Banking Without Interest

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بسم الله الرحمن الرحيم

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Foreword

Muslims the world over are today beset with a dilemma; Islam prohibits interest in the strongest terms and aims at establishing an economy free not only from all forms of interest (*ribā*) but also from what bears any resemblance to it, while the modern economy is based on interest to such an extent that it is difficult to visualise any set of economic relations where interest does not come in directly or indirectly. How to resolve this contradiction is the challenge that confronts all Muslims: intellectuals, bankers, industrialists, businessmen, policy-makers and ordinary consumers.

A group of people tried to 'resolve' this contradiction simply by denying it. They endeavoured, through a series of ingenious arguments, to suggest that Islam prohibited interest only on consumption loans, which entailed exploitation of the needy and the underprivileged. As far as commercial and productive loans are concerned, Islam has no quarrel with them. As such, there is nothing wrong with modern banking. Thankfully, this defeatist approach did not carry much weight with the Muslim people. Although the debate has continued for about a hundred years it can be claimed without doubt that there is a near-consensus amongst Muslim scholars and economic practitioners that interest is prohibited in all its forms and it is only through the elimination of *ribā* that an Islamic economy can be established. Consequently, the real question that Muslim economists and bankers have to face squarely is *how to eliminate interest and evolve new institutions and practices which would enable economic activities to flourish without resort to* ribā *in any form.*

Dr. Muhammad Nejatullah Siddiqi, one of the pioneers of Islamic economics, is also amongst the few economists who initiated research and dialogue on the subject of interest-free banking two decades before the issue came to the fore in the

context of contemporary Islamic resurgence. He is one of the dozen or so economists who have on the one hand shown genuine flexibility and creativity necessary for the evolution of a new discipline along with a strong sense of honesty, moral integrity and intellectual commitment to Islam. In his approach one finds a synthesis of a very high order. His grasp of western methodology is superb but he is also steeped in the Islamic traditions of learning. And without compromising on any of the principles he has tried to work out the Islamic economic scheme in terms of a viable programme. He has been able to develop a workable model of banking on an interest-free basis. Although a number of scholars have written on this subject during the last fifty years or so, it is no exaggeration to say that Dr. Siddiqi's book: *Ghair Ṣūdi Bankarī (Banking Without Interest),* which appeared first in Urdu in 1969, contained a full treatment of the subject for the first time. Building on what was written by Mawlānā Abul A'lā Mawdūdī and others, the author was successful in developing an elementary but thoroughly consistent and feasible model of interest-free banking. The book made its mark both in intellectual as well as practical circles. It was read and acclaimed as a pioneering work in its field. It also inspired many groups to start practicing interest-free banking, even though on a small scale. A number of credit societies were formed due to the impact of this book and a movement towards the elimination of *ribā* was generated.

New literature on monetary and fiscal economics of Islam has taken the debate to higher levels of sophistication, but this book remains a milestone on this heroic path. It is therefore a very welcome development that this revised English translation of the book is published by the Islamic Foundation. Dr. Siddiqi has received universal acclaim for his contributions to Islamic economics and has deservedly received the Faisal Award for Islamic Scholarship for 1982/1402 H. The Islamic Foundation takes pride in publishing this book and hopes it will help in clarifying many questions about the feasibility of Islamic banking.

Institute of Policy Studies,
Islamabad
6 May, 1982

Khurshid Ahmad

Preface

This work was originally produced in Urdu in 1969. Some friends in Pakistan got it translated and published it in English in 1973. Unfortunately the translation was poorly done — so poorly indeed that the text was in many places confusing and sometimes conveyed a meaning entirely different from the one conveyed by the original. All these errors have now been rectified and, so far as possible without re-doing the translation, the language has also been improved. It is hoped that the earlier editions of the uncorrected translation will now go out of circulation and out of use, being replaced by this version.

The readers' expectations from a book on interest-free banking published in the eighties will most likely be more than this translation can satisfy. It was felt, however, that nothing short of a new work would meet this demand and it would be futile to add to this book with a view to updating it. The book has a historical value even as it stands, being the first book-length discussion of interest-free banking in any language. Since subsequent development of the subject has not drastically modified the basic model incorporated in this book it deserves preservation. That it does fulfil some need is testified to by the fact that it has gone into half a dozen editions in English and Urdu, in addition to being translated into other languages. I have since written several papers on the subject which will shortly be published in the form of a collection, partly to meet the demand for an updated work.

I am grateful to Mr. Khurram J. Murad, Director, The Islamic Foundation, Leicester, for the keen interest he has shown in bringing out this book.

King Abdul Aziz University
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6 September, 1981

M.N. Siddiqi

Preface to the Urdu Edition

In prohibiting interest Islam has endeavoured to do away with a hideous form of tyranny and injustice prevalent in human society. The institution of interest is a great challenge to all those who are trying to revive and reconstruct the Islamic way of life in modern times. In the modern economic system, interest and enterprises based on interest, occupy a key position. The whole banking system rests on interest. It is, therefore, imperative that for the reconstruction of the economic system on the Islamic pattern, an interest-free banking system should be established and run successfully. Obviously, the banking system renders some fundamental and beneficial services without which no modern developed economy can be conceived. There is also a consensus among Muslim economists that even without interest a banking system can be set up to discharge all the usual functions performed by the modern banking system based upon interest. These experts also agree that the reorganisation of banking on the Islamic pattern can be brought about on the Islamic principles of *muḍāraba* (profit-sharing) and *shirkah* (partnership). But, to date, the details of how a banking system would be established on these principles and how interest-free banking would discharge all the functions of modern banks, have not been described.

In this book an attempt has been made to answer these questions and in the following pages we have presented an outline of interest-free banking. Considering the magnitude of the problem it may well be found that this is only an outline. Undoubtedly each aspect of this important problem deserves separate and detailed discussion. We have, therefore, made an effort to present the outline so as to provide a base for further and fuller detailed analysis. The opinions expressed and the outline proposed are presented for readers' consideration and comment, so that scholars of economics and Islamics may, through their own thinking and

study on this new topic, arrive at such conclusions as may be authentic from the viewpoint of *Sharīʻa* and also found viable according to the principles of economics and thus appear feasible to all thinking people.

As we have already clarified elsewhere, some of the principles of Islamic *Sharīʻa* on *muḍāraba* and partnership,[1] their repetition in this book will serve no useful purpose.

It is appropriate to mention here that our discussion of these issues rests upon the consensus view that interest is totally prohibited in Islam and that every form of interest including banking and commercial interest is unlawful.

Those who wish to study the principles of Islamic *Sharīʻa* underlying the prohibition of interest or the rational basis of this injunction may consult the appropriate references.[2] Likewise, we need not discuss the rôle and functions of modern banks or the modern theory of banking – there is already a vast literature on this subject available. What this book discusses in detail is how banking could be established on the basis of partnership and *muḍāraba* and yet discharge its usual functions. In this context the problems of monetary policy and public finance emerge at every step but these issues cannot possibly be discussed in detail in this book and are touched upon only as and when they arise.

In modern times, besides commercial banks, other financial intermediaries, e.g. insurance companies, building associations and investment corporations, are assuming increasing importance. These institutions play an important rôle in mobilising savings and investing them in specific processes of capital formation. These activities may also stimulate the flow of credit and such institutions cannot be ignored in any comprehensive discussion on monetary policies. The nature and scope of these institutions in an interest-free economy require separate study and discussion. We shall not, therefore, deal with them in this book; we shall discuss the issue in the light of the functions of money and banking as conventionally

[1] Siddiqi, M. N.: *Shirkat aur Muḍārabat kè Sharaʻī Uṣūl*, Islamic Publications Ltd., Lahore, 1969.

[2] Sayed Abul A'lā Maududi, *Sūd*, Islamic Publications Ltd., Lahore, 1961.

Maulana Mufti Mohammad Shafi, *Masa'la-e-Sūd*, Idārat-ul-Ma'ārif, Karachi, 1380 Hijri.

Mohammad Fazlur-Rahman, *T'ijāratī Sūd*, Department of Theology, Muslim University Aligarh, 1967.

Dr. Anwar Iqbal Qureshi, *Islam and the Theory of Interest*, Sh. Mohammad Ashraf, Lahore, 1946.

understood. Such an approach is unavoidable in a preliminary discussion of this nature.

While studying interest-free banking, it should be kept in mind that its successful operation can be ensured only in a country where interest is legally prohibited and any transaction based upon interest is declared a punishable offence. Moreover, where this law is not enforced strictly, the possibility that some capitalists would jeopardise the larger interest of the people for their private benefit will exist. In such a country the transaction of interest would enter the black market and disrupt the entire interest-free system. In addition to this essential condition there are some other prerequisites for stable interest-free banking, for instance, proper social security arrangements to take care of the needy consumers and prevention of hoarding through imposition of taxes. These and other similar conditions favourable to an interest-free system will obtain when, besides prohibiting interest, other Islamic laws are also enforced and steps are taken to realise the objectives held as desirable by the Islamic code of life. Besides these collective measures, if every member of the society possesses the quality of honesty, a passion for public service, and the sense of responsibility that Islam wants to inculcate in its followers, the proposed interest-free banking system can be run very conveniently and produce excellent results. A society in which the moral standards of citizens is low and in which the tendency to sacrifice public good for personal benefits is too strong and common, more and more legal action will be needed to run interest-free banking, which would in turn seriously affect the functioning of the proposed system.

This book describes how the banking system will be organised after the prohibition of interest. Its first eight chapters were published in Urdu in a prominent monthly journal *Zindagī* (Rampur), in its issues from February to December, 1967. I had the good fortune to benefit from discussions on the subject with some eminent scholars of economics, and Islamic studies. An exchange of views with Mr. Fazlur Rahman Faridi of the Economics Department, Aligarh Muslim University, has helped me in formulating my own opinions on various points. Mr Nurul Haq Siddiqui (Reserve Bank) and Dr. Wahiduddin Khan (Hyderabad), have also given valuable advice after reading the chapters published in the above journal. Professor Ali Muhammad Khusro, Director, Institute of Economic Growth, Delhi, having read these

chapters very carefully, gave me valuable suggestions during discussions. I am very grateful to these friends. I am specially grateful to Maulānā Sayyid Abu'l A'lā Maudūdī who, in spite of his pre-occupations and precarious health has very carefully read all the printed chapters one by one, and has done me the favour of giving his opinions in writing. Having benefited from the views of these scholars, I made several alterations and modifications in the printed chapters.

In view of the importance of the subject, all the literature published on it until now has been reviewed in an Appendix which may stimulate further thinking and study. Keeping in view the nature of the problems it was inevitable to make some suggestions and express an independent opinion. It, therefore, seems only right to point out here that the author himself is responsible for whatever opinions have been expressed in this book, and not the scholars who have given him their valuable suggestions. I pray to Allah that He may amply reward all those persons with whose active interest and co-operation, this work has been accomplished and has reached the readers. I also pray that Allah may guide us in further understanding this problem according to his promise: 'And for those who strive in Us, We surely guide them to Our paths . . .'

(Holy Qur'ān 29: 69)

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CHAPTER 1

Establishment of the Bank

The bank would be established on the principles of *Shirkat-e-Enan*,[1] that is, a number of persons providing share capital to be jointly invested, hereafter called 'shareholders'. The shareholders would finance enterprises on the basis of partnership or *muḍāraba* and render other services against fees or commission.

The minimum number of shareholders must be two. No maximum number can be fixed, theoretically, but for operational convenience as well as other reasons some upper limit, varying with local conditions, is appropriate. The number of shareholders should not be too great and, in their best interest, should be kept to the minimum, though always more than two.

The amount of capital provided by each shareholder may be equal or may vary. Ideally, share value might be fixed at Rs. 100,000 per share with each shareholder being allowed to secure as many shares as he wishes. The minimum and maximum limits of the subscribed capital may also be specified. Ultimately, each shareholder would become the owner of the bank, proportionately with the level of his assets in the total investment.

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[1]'*Shirkat-e-Enan* is that two or more persons participate in an enterprise with fixed amounts of capital agreeing that they will work jointly and share in profit or loss in specified proportions.'

'In case of partnership it is not necessary that every partner should share in the practical running of the business, although no partner can be prevented from such participation. In principle he shall have the right even though he may or may not exercise it.' (*Shirkat aur Muḍarabat ke Shara'ī Uṣūl*, pp. 15, 16) Markazī Maktaba Jamā'at Islāmī Hind, Delhi 6, 1969.

One individual can establish a bank with his personal capital, as can the State. But generally a considerable amount of capital is needed requiring investment by several persons. We have, in view of this, ignored alternative set-ups: but alternative set-ups (to those discussed her) *are* practicable and the results of experiments will doubtless generate still further possibilities and further discussions. However, the principles discussed here will be applicable generally, except those relating to distribution of profits among shareholders.

The distribution of the bank's profits should be proportionate to the size of capital investment (number of shares) and, for this purpose, the total profit may be divided by the total investment in the bank to determine the percentage payable to each individual shareholder. There is, however, every justification for some formula of disproportionate distribution of profit, given that some shareholders would be more competent and willing than others to effectively promote the business and take on managerial responsibilities. But for the sake of smooth running of the bank's business and for the establishment of a meaningful accounting system, profit-distribution should, in our view, be based upon the number of paid-up shares, bearing in mind (in the light of the principles of the *Sharī'a* for partnership) that if the bank goes into loss in any year, no shareholder can escape his liability, and must share the loss, in proportion to the size of his shares.[1]

Consent for the acquisition of additional capital (either on credit or on the basis of *muḍāraba*), to promote and expand the bank's business would be binding upon every partner to the bank. The bank would also be authorised to advance loans and offer monetary investment to individuals or to organisations. It would, of course, have the right to acquire the services of administrative, executive and clerical staff and to purchase and hire transport, buildings and other requisites for its use. For such expenditure and for any other expenditure necessary to operate its business on sound lines, the bank would be allowed to draw upon its capital. Conversely, every partner as a private individual would be allowed to participate in any other business or enterprise and invest money or accept loans in partnership or on the basis of *muḍāraba*. His personal enterprises, as a private individual, would have nothing to do with the business of the bank.

All major decisions regarding overall operation of the bank would be made with the mutual understanding of the partners. If, however, the number of partners is very large, power to take decisions on various matters (which should be determined beforehand) would be delegated to a Council of Representatives. Day-to-day decisions on routine business matters would be entrusted to salaried managers whose appointment and removal would rest in the hands of the partners or the Council of Representatives.

Banking is a continuous activity which cannot be reckoned to

[1] *Shirkat aur Muḍārabat kē Sharaʻī Uṣūl*, p. 21.

have ended at any one particular moment. In view of this, it is in the partners' interest to adopt an appropriate method for calculating profit and loss — the method should suit the organisation as well as the partners. It would be advisable to have the accounts of the bank audited annually and a statement of profits and losses prepared. After calculation of the overall balance, the share of individual partners should be worked out. Profit should be paid out. In case of loss, the individual partner should be duly notified that his capital has been debited by the amount of his share of the loss and has accordingly decreased. The partnership agreement should then be renewed and the business continued for the next year. The account of every financial year should be separately recorded and dividends already distributed non-recoverable, for making good losses incurred during the current year, nor should the profit earned be adjusted against the losses suffered. In the event of loss, any partner would, of course, have the right to make up the deficiency in his capital investment by fresh deposits.[1]

Every partner should have the right to withdraw from the partnership at any time. As soon as the bank receives notice of withdrawal, efforts should be made to complete the amount of the bank's collective business so that the partner's share-capital is returned along with the profit he has earned. If it is necessary to wait some time for the finalisation of the account — say till the end of the running quarter or the year — this should be done. It can be provided for in the partnership agreement that a partner may withdraw from partnership only at the end of the financial year or at the time of quarterly settlement of accounts. After the withdrawal of a partner or partners, the partnership will continue so far as the other partners are concerned.[2] In the event of a partner's death the partnership will cease to exist as far as that partner is concerned and after preparing the accounts on the lines mentioned, his share capital plus his profit or minus his loss, must be returned to his legal heirs or to the person(s) nominated in the will of the deceased. The heir or heirs may be admitted to partnership if he or they so desire and provided that the other partners do not object to their admission.[3]

[1] See *Shirkat aur Muḍārabat kē Sharaʻī Uṣūl*, pp. 38-39. In practice, such measures can be adopted that no additional capital may be demanded from any shareholder, as explained at the end of the next chapter.

[2] *Shirkat aur Muḍārabat kē Sharaʻī Uṣūl*, p. 130.

[3] *ibid.*, pp. 146-9.

As the bank would be authorised to receive and advance loans, the financial liability of a partner should not be limited to the extent of his share-capital, but should in principle be unlimited. As no theoretical limit can be imposed on the bank in the matter of receiving and advancing loans, it follows that the financial obligations of each partner will be unlimited. If the bank suffers losses such that its capital is insufficient to pay its liabilities, the deficiency must be met by the partners from their personal assets.[1] However, if a partner has undertaken some financial responsibilities in a private capacity, other partners will not be bound to share them, nor will the bank be held responsible for them in any way.[2]

[1] *ibid.*, pp. 120-1.

[2] The main purpose of unlimited liability of shareholders is to protect the interest of the depositors. But practical experience shows that in the case of bankruptcy of the bank it is rarely possible to recover enough money from the shareholders to meet the liabilities of the bank to its depositors. This has led to other measures being taken to ensure depositors' interests. These measures relate to constant supervision and regulation of banking business by the Central Bank. Depending on Central Bank supervision and control, banks may be allowed to be set up on a limited liability basis as corporations and joint-stock companies. It is not possible here to go into the juristic issues involved, but the expansion of banking business does require that banks be established on a limited liability basis and that the Central Bank enforce necessary measures to safeguard depositors' interests.

CHAPTER 2

Business of the Bank

The bank's activity may be distinguished into three categories:

A: Services which the bank renders on fee, commission, or on fixed charges.

B: Investment of capital on the principles of partnership or *muḍāraba.*

C: Free or uncharged services.

The first two categories will be discussed here; the third is discussed in the fourth chapter.

Charged Services

As income from these services may be more than their cost to the bank, they will be an important source of profit. In addition they will meet important social needs, in particular the needs of commerce. Since these services are rendered by all modern banks on fee, commission or fixed charges, but without interest, there is no reason to discontinue the practice in interest-free banks. What these services are and how they should be administered can be studied in greater detail with reference to proper sources; here we shall deal with only some of them.

(a) Safe deposits. The bank will provide lockers for deposit of jewellery, important papers and documents, receipts and other valuables; it will take responsibility for their security in return for reasonable charges.

(b) Transfer of money. Banks transfer small or large amounts through traveller's cheques, bank drafts, letters of credit and different kinds of monetary receipts, and charge a percentage commission or fee. A big bank will have branches in many places;

even banks that have no branches must deal with one another. The expenses they incur in transferring money are nominal while the services provided greatly benefit their clients. This practice should then continue even in interest-free banking and constitute a source of income for the banks.

(c) The bank service of obtaining and directing final delivery of commercial goods or other articles coming by air, sea or land, on behalf of clients, will also continue in the interest-free system.

(d) The purchase or sale of immoveable property on behalf of clients in compliance with necessary legal procedures is an important service and will be retained.

(e) Some banks help businessmen by offering expert advice, to set up or expand their business. They help them to get or buy machinery, raw materials and other requisites, in general acting as business and legal consultants.[1] To provide these services banks acquire the services of paid experts and charge a considerable fee for doing so. Such fees do not constitute interest and can be justifiably continued in an interest-free system.

(f) Besides offering advice to account holders and clients on financial matters, the banks may purchase commercial shares or invest their clients' capital in various commercial institutions on their behalf. As representatives of their clients, the banks receive profits from the shares and hold these shares for the clients. Again, these are paid services and will continue in the proposed banking system.

As hinted above, no list of paid services can be exhaustive. The needs of clients, ingenuity and progressiveness in the attitude and methods of the bank will generate new services. The banks should undertake all transactions whereby their business and the number of their customers will expand, and, with increasing experience and prestige, improved security and national or international organisation, their profits will grow. For carrying out these services quickly and conveniently the banks will receive reasonable payment from their clients, that is, from individual members of the public, business firms, government, and other agencies. Typically,

[1]David Rockfeller: *Creative Management in Banking*, pp. 40-44, McGraw-Hill, New York, 1964. A. James Meigs: 'Recent Innovations in the Functions of the Banks,' *American Economic Review*, May, 1966.

charges will exceed the cost of the services. Rates may vary from bank to bank, but competition will keep them within the proper limits. If the need arises, the Central Bank or the Government will control and limit immoderate charges.

The bank's chief source of income will come from making capital available to those interested in business on the principles of *muḍāraba*[1] or *Shirkat-e-Enan*. As these two forms of investment are of a different nature and are viewed differently in the injunctions of *Sharī'a*, they will be discussed separately.

A Partnership through Bank Capital

One way of profitably using capital is for the bank to become a partner in business with the entrepreneur. Both entrepreneur and bank share in the investment and run the business. The paid representatives and experts of the bank work alongside the entrepreneur. A partnership deed would specify the nature of business, the limits within which it is to be conducted, length of the term of agreement, and the proportion in which profits are to be distributed. The loss, however, must be borne proportionately to the investment of capital. At the completion of business or at the expiry of the fixed term or at the time of winding up of business, the profit or loss will be determined after completing the records of business and then shared out according to the above-mentioned principle. The net capital will be returned to the partners along with profit after deducting any loss.

When the bank signs a partnership contract, provision must be made that the financial liabilities do not exceed the contributed capital. This is possible when the bank has invested its capital on the principle of *Shirkat-e-Enan* and its business is run on the condition that it will not be expanded beyond the partnership capital: when taking or giving loans or credit a limit should be set such that, at any given time, the financial liability of the joint

[1]'*Muḍāraba* means that one party should provide capital and the other should transact the business under the agreement that he will receive a fixed percentage of dividend in the overall profit of the business.' Even in *Muḍāraba* those who procure capital and those who conduct the business may be different individuals: those who have obtained the capital may themselves jointly transact the business; or the capital may belong to one person while others transact business with it; or several persons procure the capital and only one transacts the business. Loss means the diminution of the original capital. It will, therefore, be distributed proportionately according to the size of capital invested in the business and the investors will bear the same. The party which has not made any investment in the business will not bear any loss. *Shirkat aur Muḍārabat kē Shara'ī Uṣūl*, pp. 17-18.

business will not exceed the total of its cash deposits and/or other assets.

We have already explained the principle of limited liability while describing the *Sharī'a* laws of partnership and *muḍāraba.*[1] This restriction is needed for the reason that, as will be explained in the following pages, a large part of the bank's capital will be generated by those who deposit money on the principles of *muḍāraba.* To run the banking system it is necessary to limit the financial liabilities of these account holders. This is possible only when the bank invests its capital with limited financial liability.

In the case where it provides capital on the principle of partnership, the bank will be free to settle its own terms with its partners for the division of profit. But it is necessary to fix the profit-shares of the bank and of its partners in percentages, and not to earmark any fixed amount for any party. With this condition the bank is free to agree to a division of profit proportionate to the invested amount or to settle other ratios. The bank will be free to agree to different ratios of profit-sharing with different partners.

If at the expiry of the partnership the invested capital of the bank is returned along with profit then this profit will go to the profit pool of the bank. If a loss occurs in some partnership this too will be accounted for out of that pool. In the fixing of profit or loss some problems will crop up. For instance, how will the profit of a running business be fixed? Or, what will be the method of entry or withdrawal from a running business? How will profit and loss be determined in cases where the bank invests its capital on the principles of *muḍāraba*, and the business partners have invested the capital of other parties on the same terms of partnership or *muḍāraba* etc., etc. These questions will be discussed later on. But it is essential to underline here that long-term loans should not be taken out on behalf of the joint business. Loans increase the financial liabilities of the business and as has been explained above, any business in which the bank is partner should be run in such a way that it remains within the limits of capital made available on the principles of partnership and *muḍāraba.*

Short-term loans are a different problem altogether and will be dealt with in subsequent pages. From the point of view of *Sharī'a*, there is no harm in the bank's investing on the principles of partnership and then not participating in the running of the

[1] *ibid.*, pp. 117, 121.

business, but on those principles it will have the right to participate and can exercise that right whenever it thinks fit. In our opinion, this is an impracticable and undesirable situation because the business partners will prefer to get capital on the basis of *muḍāraba.* So far as profit-sharing and liability for loss are concerned there is no difference between *muḍāraba* and the partnership in which one partner does not share in the running of the business. Whenever there is a loss it will be divided proportionately to the investment. As the proportion of profit will be settled by mutual agreement of the bank and the partners, it is likely to be so divided that the share of the bank is the same in the profit in *muḍāraba* and in the proposed form of partnership. This means that if the bank decides not to participate in the running of the business, although supplying capital on the principles of partnership, its share of profit from the joint capital will not be proportionate to its investment, but less than that, so that the working partners are suitably rewarded in case of profit. If the bank does not agree to such an arrangement no party will be willing to enter into a contract of partnership with the bank. Any party will prefer *muḍāraba* in which case its share of profit earned through the capital provided by the bank, is specifically fixed.

This may be illustrated by an example. Suppose a businessman is investing Rs.100,000 and wants the same amount from the bank. In one form of partnership, the bank will have a partnership contract and share in running the business. Let us suppose that in this case the principle of equal distribution of profit is agreed. If the profit in the business is Rs. 20,000, then Rs. 10,000 will go to the bank and the same to the business partners.

In a second form of partnership the bank enters into the contract of *muḍāraba* and it is settled, let us say, that the bank will receive half of the profit from its investment. If in this business, the profit is Rs.20,000, the bank will get Rs. 5,000 and its partner Rs. 15,000. Out of this, the sum of Rs.10,000 is the profit on his own capital and Rs.5,000 is returned for his successful transaction with the bank's capital.

In a third form of partnership the bank invests Rs.100,000 on the principles of *Shirkat-e-Enan*, but decides not to take any part in the practical running of the business. In such a case the business party agrees, let us say, that the bank will get one-quarter of the profit. In this case, out of the profit of Rs.20,000 the bank will get Rs.5,000 and Rs.15,000 will go to the business parties. If the bank

had demanded one-third of the profit, the business partner would have preferred the *muḍāraba* form of partnership, mentioned above.

If the bank has worked on some other profit-ratio, laid down in the above-mentioned contract of *muḍāraba*, then, in the light of that, the third form may be amended. But it is clear that in this case there will be practically no difference between the second and third form and it will be useless to discuss them separately. We are justified in concluding that if the bank wishes to take a practical part in the management of the business it will have to invest its capital on the principles of partnership and if it does not want to take practical part in the business then it will provide capital on the principles of *muḍāraba*.

The history of modern banking shows that in most countries most commercial banks have refrained from investing money in industrial, commercial and agricultural business on the principles of partnership, although in certain periods in certain countries they have done so.[1]

The aim of this book is to give a popular, practicable and understandable outline of interest-free banking, so we shall refrain from a detailed discussion of the special banking referred to above. In subsequent pages the form of *muḍāraba* investment will be discussed in more detail because, in our view, the one comparatively safe form of profitably using capital (for the ordinary interest-free bank) is to provide capital to business parties on the principles of *muḍāraba* without participation in the management of the business. As indicated above, an ordinary bank might also adopt the methods of investing on the principles of active partnership but it is very important in this case that the bank does not expand the joint business beyond certain limits, i.e. that large sums are not invested over very long periods.

[1]Direct bank participation in business has played a tremendous role in the industrial development of Europe. In France even now some banks do so, and in Spain this procedure is still in practice and the representatives of the bank participate in the management of the business institutions. See R. S. Sayers: *Banking in Western Europe*, Oxford, 1962, p. 20, 365.

B *Muḍāraba* through Bank Capital

In case of provision of capital on *muḍāraba* the bank will not be authorised to interfere in the routine transaction of the business. Some conditions may, however, be settled in consultation with the entrepreneur, at the time of finalising agreement deeds, regarding the rights and obligations of the entrepreneurs, to be complied with by him. For instance, if it is so agreed that the capital from the bank will be invested in a particular trade or industry it will not be feasible for the entrepreneur to invest it elsewhere. If it is set out in the agreement that the entrepreneur shall not be authorised to procure additional capital for investment from any other partner by entering into an agreement with him on the basis of *muḍāraba* or partnership, this precondition also shall be complied with. It may also be set out in the agreement that the entrepreneur will not buy any goods on credit. Conversely, such conditions may be included in the agreement that no restriction is imposed upon the entrepreneur, and he may be made independent in matters pertaining to procurement of further capital for investment, keeping in view the size and future expansion of the enterprise as well as execution of fresh agreement deeds with other partners.

In spite of the above condition preventing the bank from interfering in the routine transactions of the enterprise, the bank will be empowered to prevent the entrepreneur from taking such actions as may result in a loss due to failure to plan properly or other irregularities. The bank shall always be empowered to audit the accounts and acquire information regarding important decisions taken by the entrepreneur. It will, however, be essential for the bank to keep essential secrets, as well as for the entrepreneur, and to refrain from action detrimental to the interest of the enterprise. Such or other similar clauses against possible malpractice or lack of proper care and vigilance may also be incorporated in the agreement. It is very desirable that all the important functions relating to all the bank's activities, e.g. audit of the accounts and their supervision etc., should be conducted through authorised officials of the Central Bank, whose area of concern should include whatever irregularities (like lack of planning and care) may warrant authorisation to terminate the agreement deed. If the agreement has been entered into for a specific term and the bank wishes to cancel it before expiry of the term (on account of irregularities, etc.) it should be obliged to appoint some responsible

officials or a tribunal to arbitrate the problem. These officials or tribunal should decide a case after hearing both parties and their decision should be binding upon both parties. Every legal protection should be afforded to the capital supplied by the bank to the entrepreneur so that it may be repaid with profit or loss at the scheduled time.

In our opinion the most appropriate procedure for the *muḍāraba* agreement between bank and entrepreneur (to be dealt with in our future discussions) would be that the entrepreneur should be able, in addition to investing his own capital, to procure further capital from others on the principle of *muḍāraba*; he should also be able to purchase or sell goods on credit within the limitations of the total capital and to procure short-term loans for investment in the business. The nature of the business should, certainly, be settled in principle, but the entrepreneur should be afforded fullest freedom for working out the details. If the entrepreneur wants to transact business in partnership with another party, this point should be clarified at the time of execution of the agreement and the consent of the bank should be obtained for the same.

A huge amount of capital is permanently required for investment of a short term nature. It may be, for instance, that manufactured goods or a harvest are virtually completed, but before either can be sold in the market and their production costs recovered, these costs must be met — employees have to be paid, raw materials bought and transported etc. Such needs cannot be met through procurement of capital on the basis of partnership and *muḍāraba* but they can be met through temporary loans to be repaid immediately after the sale of goods, the finished goods being security against repayment. Loans for the repayment of which substantial resources exist can be considered as self-liquidating loans. Short-term loans made by modern banks are mostly of this nature. It is therefore desirable for the bank to allow its entrepreneurs to draw such short-term loans while executing the above agreements. The questions why and by whom such loans will be advanced in the interest-free system will be discussed in the following pages.

In *muḍāraba* the entrepreneurs will not be allowed to acquire long-term loans for the business for the simple reason that this pushes the financial liabilities of the partnership beyond limits of the jointly-covered capital. The entrepreneur is not authorised to

increase the financial liabilities of the bank, and if he procures additional loan for investment in the business it will be regarded as his personal capital and he will be personally responsible for its repayment. The partnership itself will have no responsibility to repay such loans. It may also be noted that in an interest-free system availability of long-term 'loans' will hardly be a practical possibility as these loans will bring no returns to the lender.

As regards purchase of goods on credit, it will be required that the debts of the enterprise should at no time exceed the business capital. We have already explained the advantages of purchasing goods on credit within the limits of the capital[1] — the entrepreneur will be empowered to do so according to the terms of the agreement deed. As the interest of the entrepreneur also lies in the profitability of the business it is assumed that he will adopt a responsible attitude in this regard, given that his own personal capital is also at stake.

The bank will receive a fixed ratio of the profit earned from the capital provided to the entrepreneur, as mutually agreed between the two parties. The bank may either fix different ratios of profit with different entrepreneurs or work on a fixed figure in all cases. The examples below are based upon the assumption that the bank will ultimately fix a ratio of the profit, half for itself and half for the entrepreneur. But it is possible in practice to fix any other ratio for division of profit, varying with enterprise and/or with region.

Distribution of Profit between the Entrepreneur and the Bank

In studying the principle of division of profit, it should be borne in mind that the conditions of partnership may vary, for example:

(1) The entrepreneur may transact the business with capital procured from the bank only, and with no other capital.

(2) The entrepreneur may invest his own capital in the business in addition to capital procured from the bank.

(3) The entrepreneur may invest personal capital loaned to him otherwise than by the bank.

(4) The entrepreneur may invest additional capital from another party on the basis of *muḍāraba*.

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[1] *Shirkat aur Muḍārabat kē Shara'ī Uṣūl*, p. 112, 116.

(5) The entrepreneur may enter into (active) partnership with another entrepreneur whose capital is also invested in the business.

(6) All the above conditions may apply at one time, namely, a business in which the personal capital of the entrepreneur, the capital provided by a partner, and the capital provided on the basis of *muḍāraba*, are invested together.

In each of these cases, the capital of the bank has been procured on *muḍāraba* and not on the basis of partnership. In the accounts following, it has been assumed that a sum of Rs.100,000 has been acquired from the bank on condition that half of the profit earned from it will go to the bank and half to the entrepreneur:

1 In situation (1), if there is a profit of Rs.10,000 a sum of Rs.5,000 will be paid to the entrepreneur, and the remaining Rs.5,000 together with the capital of Rs.100,000 will be refunded to the bank. If the business results in a loss of Rs.10,000 the capital is reduced to Rs.90,000 and this amount will be refunded to the bank, which must sustain the loss of Rs. 10,000. The entrepreneur will neither receive nor pay anything. If the bank has fixed another ratio of profit division, for example, 40% for the bank, 60% for the entrepreneur, or vice versa, the profit will be accordingly divided. But in case of loss, the loss will be entirely sustained by the bank. In *muḍāraba* a loss takes place only in the capital and as such is borne by the owner of the capital. This principle is not influenced by the ratio for profit division as laid down in the *muḍāraba* agreement.

2 In situation (2) the entrepreneur himself invests Rs.100,000 in addition to the capital of Rs.100,000 procured from the bank, and works the business with the joint capital of Rs.200,000. Supposing there is a profit amounting to Rs.20,000 in the business the same will be first spread over the total capital and then half of the profit earned from the bank's capital will be paid to the bank, the balance going to the entrepreneur. A sum of Rs.15,000 will thus be the entrepreneur's share, and Rs.5,000 the bank's. The bank will get back its capital and the entrepreneur will get back his. From the profit of Rs.15,000, Rs.10,000 is profit on his own capital and Rs.5,000 is his share in the profit earned from the capital invested by the bank which is, of course, his reward for the successful operation of the business with the above capital.

If the business results in a loss amounting to Rs.20,000, the bank will bear one half, and the entrepreneur the other half. As explained earlier, loss is reduction in capital and is borne by the owner thereof according to the ratio of his investment.

3 In situation (3), the entrepreneur invests a capital of Rs.100,000, acquired on loan on his own responsibility, besides the Rs.100,000 procured from the bank. The entrepreneur's private borrowing will be reckoned his private capital and he will get profit or make loss as described above for situation (2). If the business gains Rs.20,000, Rs.100,000 plus Rs.5,000 will be handed back to the bank; and Rs.100,000 plus Rs.15,000 will remain with the entrepreneur who must of course return the Rs.100,000 he borrowed privately. In case of a loss of Rs.20,000 he will repay Rs.90,000 to the bank, and must make up the Rs.10,000 wanting in the Rs.100,000 which he borrowed on his own responsibility. The bank does not share in responsibility for the loan he obtained privately.

4 In situation (4) Rs.100,000 has been acquired on the basis of *muḍāraba* from another party (the investor) in addition to the Rs.100,000 from the bank and a third sum of Rs.100,000 invested by the entrepreneur himself. Thus the business is run with a total capital of Rs.300,000. Supposing that in this deal with the investor it has been decided that half of the profit earned from his investment will be paid to him and half go to the entrepreneur, then, from an overall profit of Rs.30,000, Rs.20,000 will go to the entrepreneur and Rs.5,000 each to the bank and to the investor. The bank, the entrepreneur, and the investor will also get back their capital. Thus, the principle of profit-sharing has remained unaffected: the whole profit is divided over the whole capital; the entrepreneur is paid for his services from this overall profit according to the terms and conditions settled between him and the bank, and between him and the investor.

If the business results in a loss amounting to Rs.30,000, that loss will be divided equally (or proportionally, as the case may be), over all three capitals. The bank, the entrepreneur and other investors will each suffer a loss of Rs.10,000 and get back a sum of Rs.90,000 only. No portion of the losses suffered by the bank and the investor will be borne by the entrepreneur.

5 In situation (5), the entrepreneur procures a sum of Rs.100,000

from the bank on *muḍāraba*, and with the bank's consent, enters into a partnership agreement with this capital with a second entrepreneur, who invests a capital of Rs.100,000 in order to run the business on a total capital of Rs.200,000. It has also been settled between the two entrepreneurs that they will share in the profit equally, and it has been agreed between the bank and the entrepreneur that the bank will receive half of the profit earned by the entrepreneur and half will go to him. Thus if the business makes a profit of Rs.20,000, Rs.10,000 will go to the second partner on his investment of Rs.100,000 on the basis of partnership; Rs.5,000 will go to the bank which provided a capital of Rs.100,000 on the basis of *muḍāraba* and Rs.5,000 will go to the entrepreneur who put in the effort of setting up the business. If the business results in a loss of Rs.20,000 the bank will sustain one half, the remainder to be sustained by the second partner who provided capital on the basis of partnership. The first entrepreneur who made no investment will not share the loss, nor will he receive any reward for his business efforts.

In the above situation it would be perfectly in order if, in spite of making equal investment it were settled that the first entrepreneur and his partner should get 60% and 40% respectively from the profit earned, or the first entrepreneur receive one-third and his partner two-thirds. Under all these circumstances the bank would receive an already fixed ratio as its share in the profit which the entrepreneur would get from his partner under their agreement deed. It would also be in order to carry out the agreement with the condition that from the total profit the second entrepreneur should get 50% and the bank 25%. The remaining 25% would go to the first entrepreneur who had procured capital from the bank. The exact figures in any of these examples may be varied in individual cases.

6 In situation (6), there are a great many possibilities, since it combines some of the principles presented in the preceding lines. It must suffice to understand the underlying principle of distribution: Suppose that the entrepreneur invests Rs.100,000 in a business run by his partner A (who also invests Rs.100,000), and on behalf of this joint venture, he acquires Rs.100,000 from the bank on the basis of *muḍāraba*, and a further Rs.100,000 from another partner B. It is decided between the bank and B that half of the profit earned on their total capital will be paid to the bank and

between the entrepreneur and A that they will divide equally the total profit of their joint venture. This business is, therefore, run with a total capital of Rs.400,000. If it gains Rs.40,000, the bank would get Rs.5,000 and partner B would get Rs.5,000. Partner A and the entrepreneur would each get Rs.15,000. The principle of distribution of profit is that first of all the total profit will be spread over the total capital to give profit of Rs.10,000 per 100,000 invested. According to the agreement deed of *muḍāraba*, partner B and the bank would receive half of the profit, i.e. Rs.5,000 each. The balance, Rs.30,000, of the total profit on the joint venture must be divided according to the agreement deed between the entrepreneur and partner A.

If the business results in a loss of Rs.40,000 it will be divided equally between the bank, partners A and B, and the entrepreneur, because their capital investments were equal.

From the bank's viewpoint the common factor in all these cases is the precondition that if the business results in a loss the loss is sustained in full by the bank according to its full share in the joint capital. If there is a profit the bank must pay to the entrepreneur a fixed ratio from its profit earned on its capital investment. We have illustrated in the examples above that the underlying principle is not influenced by the nature or the size of the entrepreneur's business into which the bank has put its capital on the basis of *muḍāraba*. In other words, as regards profit-sharing or loss, it does not matter whether or not the other partners have also invested their capital in the enterprise.

We have not so far mentioned short-term loans taken out by the entrepreneur. Such loans will be repaid before accounting for overall profit and loss and may not be counted with the original capital investment. As explained above, the percentage loss and profit in the business will be determined only on the basis of the capital including long-term loans invested. The short-term loans are only the credit transactions of the business. Undoubtedly though, sales on credit do expand the business and enhance the opportunities for profit, and, since the credit transactions are based upon the capital used to run the business, profit and loss will be accounted for on the basis of the invested capital. The same is the case with (short-term) loans of smaller amounts. These loans do expand and modernise the business and provide opportunities for earning profit but they are not included in the capital when

accounting for loss and profit.

It is possible for the bank to enter into various forms of agreement with one or more entrepreneurs or business institutions, and it is also possible that they may invest further capital procured on *muḍāraba* or an active partnership basis with yet other parties. In all the different possible permutations, the underlying principle of profit-sharing or loss-sharing remains unaffected. First of all, the share of investors on the basis of *muḍāraba* should be paid out of the total profit to the business in which capital was invested on that same basis, and also some capital was procured through loans taken out with the consent of the partners in the business. The balance of profit should then be divided among the business partners according to a predetermined ratio and, in case of loss, the loan which was taken out on behalf of the joint business should be repaid in full. The balance of loss will be borne by the entrepreneurs and the partners proportionately according to their capital investment. In our opinion the bank will not invest in a business in which capital got on long-term loans is also being invested. But capital for investment, got on the basis of *muḍāraba*, may be approved by the bank, as well as capital got on the basis of (active) partnership. The principle of division of profit and loss has been illustrated in the examples above. The same rules apply to short-term loans, taken out on behalf of the partnership, which have been explained above in the context of *muḍāraba* agreement.

Investment in Running Business

With a new enterprise, there is need only for a mutually agreed audit, and no theoretical problem arises in determining the profit or loss for the different parties who have invested along with the bank. But there is also the possibility that the entrepreneur may be running a factory, or some other agricultural, industrial or commercial enterprise, and approach the bank for a loan. The bank must ascertain what amount of capital is already invested in the business before investing its own capital. The bank should also work out fully the total assets of the business, for future profit or loss cannot be determined without this information. The most popular method of making such assessments is to determine what all the moveable properties (machines, manufactured goods, raw materials, etc.) and all the immoveable property (buildings,

grounds, etc.) would fetch if put on the market for sale. After this, the immediately available and repayable amounts owed to the enterprise should be included in the valuation of its overall assets. The total thus accounted for will constitute the original capital over against the capital provided by the bank: the bank's profit or loss from any future transaction will be based upon the relation between the two. It is immaterial whether the owner of the business is the entrepreneur himself or whether there are also other partners providing further capital on the basis of *muḍāraba*, prior to the procurement of capital on that basis from the bank.

The method of assessment of the value of the business should be one on which the bank and the entrepreneur both agree. The services of experts may be hired, where necessary, and where both parties can trust the experts' professionalism and integrity. Regarding monies owing to the enterprise at the time of execution of the agreement a workable alternative may be for the entrepreneur to undertake responsibility for them; in this case such monies will not be accounted for in the valuation of the assets of the enterprise.

A similar problem arises where the entrepreneur decides to procure additional capital from the bank on the basis of active partnership, to jointly run the business. Some scholars have considered it essential that both parties should join the enterprise with capital in cash — to avoid eventual dispute and disorder. It is, however, very tedious to do this — it is even detrimental to the interest of the business, slowing down the economic process while the running enterprise is converted into a joint one. We therefore consider it proper to adopt the above method in industrial enterprises. The capital investment of the entrepreneur may be reckoned in the total assets of the business and the bank should add its capital thereto, preferably in cash, the future account between the parties being maintained on the basis of the above two capitals. The method of valuation of the business's assets should be agreed to by both parties, thus preventing any possibility of dispute or misunderstanding at a later stage.

A question arises regarding the length of the term of agreement. If the nature of the enterprise is such that after a fixed period it may be reckoned 'complete' and the capital invested converted into cash, the bank may wish to make the investment over the whole period. No problem arises in reckoning up profit or loss for, on completion of business, the entrepreneur will have the account

audited and divide profit or loss accordingly. But seeing that, in modern times, industrial enterprises continue indefinitely, their time of completion can hardly be determined beforehand. Under such circumstances the bank may pursue either of two alternatives. Either it may provide the capital for a specific period, or make the investment for an indefinite period, in which case it should be able to withdraw its capital as and when it desires. In both cases the same method of valuation of the assets of the business will be employed as was explained above for refunding capital and auditing the account. One reason for this is that if the entrepreneur continues the business, even after refunding the bank's capital to the bank, it may not be possible to audit the account on conversion of the whole capital invested into cash — the more so as, in reality, the decision to sell goods, machines and raw materials put in order to clear the account, cannot be taken. It would be fatal for any industrial enterprise to convert all its assets into cash simply to settle up its account; such a step could have serious consequences, not only for the entrepreneur but for the whole economy. Ultimately this may mean that, in practice, industrial entrepreneurs would not get capital from the bank. In the light of this it seems to be vital that the final division of loss or profit and audit of the account are reckoned according to the above method of valuing the assets in the joint capital. The bank would eventually get back its capital in cash, and its legitimate profit in cash, according to the accounts maintained. The procurement of cash to make these payments to the bank will be the responsibility of the entrepreneur who, while wanting to continue the business, also wants to refund the bank's capital. (What methods he adopts to achieve this have no bearing on the present discussion.)

As has already been explained in the discussions on the Islamic principles of partnership and *muḍāraba*, it is, in the opinion of scholars, essential to convert the capital of the enterprise into cash for the sake of proper accounting and final division of profit or loss.[1] This argument is aimed to avoid any possibility of fraud in the accounts, resulting in a misunderstanding or usurpation of the rights of any of the partners. Without doubt, conversion of the assets into capital would achieve that objective. But, while this is possible in agricultural and commercial enterprises, to do so in modern industrial enterprises may entail many individual and

[1]For detailed discussions, see *Shirkat aur Muḍārabat kē Sharaʿī Uṣūl*, pp. 41, 48.

social disadvantages. In our view if valuation of the assets of the enterprise is carried out in a way that both parties can agree to, no serious problem need arise, when profit or loss are worked out.

In order to make auditing of the account and study of the business transaction more convenient, it should be obligatory upon all the partners to prepare a statement at suitable intervals (e.g. annually or half-yearly) to determine the total financial assets of the enterprise according to modern accounting methods. The bank should also keep such intervals in mind when making investments — that is, fix a quarterly or yearly or some other period — and on completion of this period either partner should be empowered to terminate the agreement. In that circumstance, the bank's capital should be refunded and after accounting for profit or loss, its account cleared. If, however, the partners so wish it, the agreement may be continued for another quarter or year, as jointly agreed. In such cases division of profit or loss will be final and have no bearing upon succeeding extensions of the agreement. Obviously, with joint consent, the partners may keep the agreement running continuously and indefinitely. They may wish to postpone division of profit or loss to a future date, and regard any intermediate settlement of account as temporary. In case of fixed term agreement, the final settlement of account would only be possible before the end of the term if both (all) parties agree to this, or if one partner dies in a circumstance that may necessitate (early) termination of the agreement.

If an entrepreneur who already has bank capital invested in his business, wants to make further investment with additional capital from either the bank or another entrepreneur, the financial state of the business must be assessed with a view to the proposed additional investment at the time of its proposal, and in the manner outlined above. Every partner, on introducing new capital, becomes a shareholder in the enterprise under a new agreement, and it is then necessary in theory to clear the account of those investors whose capital is already invested in the business, their current profit and loss having been determined. In practice, it is not necessary that either their capital actually be refunded or their share in the profit of the business. It may be sufficient to reckon up the value of such capital together with their profit and loss, and amend the agreement accordingly.

Even if the bank has provided the entrepreneur with capital for an unlimited period, the same method of accounting and division

of profit or loss can be adopted after suitable intervals, quarterly or yearly, etc. As the bank would need to determine the total profit or loss after the completion of its clients' accounts, the fact of a long-term investment should not prevent the fixing of a time limit for the determination of quarterly profit or loss and continued payment to the bank of profit on its invested capital.

So far we have discussed the procedure of investment of capital on the basis of (active) partnership or *muḍāraba*. But for future discussions we will assume that the bank makes investment on the basis of *muḍāraba* only. This removes possible complications in the discussion while not significantly influencing its outcome. Keeping all aspects of the proposed banking system in view, it can be readily imagined, if the bank does not offer partnership on the principles of *Shirkat-e-Enan*, alongside loans on *muḍāraba*, what influence this will exert on the overall banking system and what modifications will be needed in detailed implementation.

It will be useful at this point to go over some of the points we have made so far:

1 The bank would provide the entrepreneurs with its capital on the basis of *muḍāraba*.

2 The whole of any loss incurred on the capital provided by the bank would be borne by itself.

3 The financial liability of the bank must not exceed its capital. (The highest loss to be suffered can thus be equal to the total capital invested.)

4 The distribution of profit may take place before the closing audit of the accounts.

5 On completion of business the bank may have its capital refunded along with any increase or decrease according to profit or loss.

6 At the outset it is essential to determine the extent of capital already invested in the business or that which is being invested now in addition to capital provided by the bank on an earlier occasion.

7 It is necessary to draw up a fresh agreement for any additional investment in the business whether of capital from another source or from the bank itself.

8 In cases of both definite or indefinite term investment the bank may at any time withdraw its capital with the consent of the entrepreneur. The bank may, however, be required to wait for some time for the completion of its account which may extend to a quarter.

C Purchase of Shares of Entrepreneurial Institutions

An established method used by banks to earn profit on their capital is buying shares in commercial or industrial enterprises. In modern times many businesses raise capital through the sale of shares. As a rule, ownership of shares makes their owner a partner in a joint enterprise proportionately according to the size of his shares. For example if a company has been set up with a capital of Rs.1,000,000 with an individual share-value of Rs.1,000, the owner of one share will own 1/1000 of the company. Company profit is equally divided among its shareholders, but in the year when there is a loss, no profit is divided, nor is compensation demanded for such losses from the shareholders. On the contrary when there is a profit at a later stage or there has been a profit in the past which has not been divided it is used to make up the losses and if any profits are left over these are divided among the shareholders. This is a somewhat rough and ready description of the shares–dividends system, but it is not unrealistic and can be made the basis for further thinking on the system under consideration.

Shares can be purchased and sold on the market. Their fluctuation in value is greatly dependent upon their existing or expected profitability. The process of buying and selling these shares may continue even in an economic system based on Islamic principles. Undoubtedly many questions arise regarding the financial liabilities of the shareholders, their rights of interference in the joint enterprise, and the selling or buying of shares, but these are not questions that cannot be answered. Appropriate amendments in the present structure of companies to abolish speculation, to control distribution of profit on shares in the business, and to formulate necessary rules and regulations for purchase and sale of shares, can bring modern practices into line with all the prohibitions under Islamic *Sharī'a*. Although we cannot discuss all these issues in this book in detail we will continue our discussion on the assumption that dealing in shares will not only continue in an interest-free economy but indeed flourish as a result of the

prohibition of interest. Ultimately all forms of commercial shares connected with interest and those which guarantee minimum rate of profit are out of the question in the context of our present discussion. We shall be referring below only to the common stock shares, whose profits depend upon the success (profit) of a company's business.

The banks may invest a portion of their capital to purchase these shares which may yield annual profit. They can also make arrangements such that they always get a profit on these shares purchased from various enterprises.

A major advantage of investing capital in shares is that the bank may sell them as and when necessary. As will be evident from the subsequent discussions, it is essential for the bank to maintain liquidity. The ownership of shares will help to achieve this.

CHAPTER 3

The Bank and the Owners of Capital

In the preceding chapter we saw how a bank might earn income — through fees, commission or fixed charges for bank services; through investment of its capital (on the basis of *muḍāraba* or (active) partnership) in commercial or industrial enterprises; through the purchase of company stocks or shares. We mentioned only the initial capital of the bank, provided by the founding shareholders who floated the bank. In the present chapter, we shall describe some of the methods that the bank may use for securing further capital.

Acquisition of Additional Capital on the Principles of *Muḍāraba*

The bank will seek to persuade the general public to put their savings with the bank on *muḍāraba*, and it will transact business as described in Chapter 2. The profit earned in this business will be distributed in such a way that the bank will get a specified portion of the profit according to an agreed ratio and the rest will go to those who have deposited capital in a '*muḍāraba* account'. We shall explain below the terms and conditions of the contract between the bank and '*muḍāraba* account-holders', hereafter called the depositors. Besides depositors other persons can also place money in this bank in a 'loan account' whose nature and conditions of use will be explained later in this chapter.

Muḍāraba Account

The bank will make the following contract with depositors who hold a *muḍāraba* account:

1 The bank will invest their capital along with its own. The aggregate profit earned on the total capital will be divided over it.

After such a division an agreed percentage or fraction of the profit will be given to the bank and the rest will be transferred or given to the depositors. The proportion of profit-division will be determined with the mutual consent of the parties concerned.

2 If the bank suffers a loss, the loss will be spread over the entire capital of the business. The loss apportioned as a result of such calculation will be borne by each account-holder (depositor).

3 Total liability of an account-holder will not exceed his total deposits which means that the maximum loss he could suffer would be his total deposits. If the bank invested capital in a business and expanded it beyond the limits of *muḍāraba* deposits and shareholders' capital and consequently suffered so much loss that the entire investment was lost but the payable loans still remained, then the *muḍāraba* account-holders would not be asked to pay in more funds. Such a demand can only be made from partner-shareholders.

4 If the depositor wishes to continue the contract, the profit earned in the subsequent quarter will first be set against the past loss, then remaining profit, if any, will be divided among the parties according to an agreed ratio. It is also possible for any depositor to study the quarterly and final accounts and decide to withdraw his money together with profit or loss. He can again deposit it in the bank under a new *muḍāraba* account. In this case actual withdrawal is not necessary: it should be sufficient after settlement of account to inform the bank about renewal of the contract. Future profit or loss has no connections with past profit or loss in the case of a renewed contract.

5 At the end of each quarter every depositor will be informed about his profit or loss. He will have the right to dissolve the contract and withdraw his money settling his profit or loss account, or he may receive the instalment of profit and agree that this distribution of profit is tentative and in future, if there is a loss, it may be adjusted against this profit.

6 The depositor can demand his money whenever he likes. But for the account of profit and loss he must wait till the end of the current quarter unless the bank agrees that the preceding quarterly account can be made the basis for clearing the account. The money in *muḍāraba* account can be neither drawn upon nor

transferred to other persons through cheques. To withdraw the deposit, notice should be given of the intention to do so — unless the bank has waived its right to appropriate notice in any particular case. Money may be deposited in a *muḍāraba* account without fixing a time-limit and/or for a fixed term, for example, three or six months, etc.

7 To meet the demands of the *muḍāraba* account, the bank will at the end of each quarter, settle the account of its whole business and determine the total profit or loss. Assessment of the account value in the case of those parties by whom capital is provided on the principles of *muḍāraba*, will be accordingly settled with them.

8 New deposits in *muḍāraba* account will be accepted normally at the beginning of every quarter. Deposits made in the middle of a quarter will be received but if immediate use of the money is not possible, it will not be included in the current quarterly profit/loss account. Nevertheless, if it is possible for the bank to use mid-quarter deposits against expenditure (on the purchase of shares, or on provision of capital on *muḍāraba* basis, or on services) then the bank will include such deposits in the accounts for the current quarter, keeping in mind, of course, the length of time they will be used. Competition among the banks to attract savings and capital will ensure the continued supply of money in the form of deposits in the *muḍāraba* account. But the controlling authority (i.e. the Central Bank) will exercise proper supervision to see that the accounts are kept in such a way that none of the parties is deprived of his rights. The accounting methods used should be modern and proof against every sort of fraud and deception. To safeguard the depositor against deception or misinformation or inadequate information, the Central Bank will frame modern and foolproof rules and regulations, with the help of experts, keeping in mind the interests of all parties.

That the amounts in *muḍāraba* account should accumulate for a quarter or more, and that new deposits or withdrawals should be made at the end of a quarterly period, is merely a suggestion that we put forward. Such a procedure would protect the account from deception, fraud and misinformation and guarantee justice. This is why we have proposed that every business party, provided with capital by the bank, should exchange quarterly accounts with the bank, so that the ongoing profit or loss of either can be studied. It is clear that the determination of profit/loss of any depositor or

After such a division an agreed percentage or fraction of the profit will be given to the bank and the rest will be transferred or given to the depositors. The proportion of profit-division will be determined with the mutual consent of the parties concerned.

2 If the bank suffers a loss, the loss will be spread over the entire capital of the business. The loss apportioned as a result of such calculation will be borne by each account-holder (depositor).

3 Total liability of an account-holder will not exceed his total deposits which means that the maximum loss he could suffer would be his total deposits. If the bank invested capital in a business and expanded it beyond the limits of *muḍāraba* deposits and shareholders' capital and consequently suffered so much loss that the entire investment was lost but the payable loans still remained, then the *muḍāraba* account-holders would not be asked to pay in more funds. Such a demand can only be made from partner-shareholders.

4 If the depositor wishes to continue the contract, the profit earned in the subsequent quarter will first be set against the past loss, then remaining profit, if any, will be divided among the parties according to an agreed ratio. It is also possible for any depositor to study the quarterly and final accounts and decide to withdraw his money together with profit or loss. He can again deposit it in the bank under a new *muḍāraba* account. In this case actual withdrawal is not necessary: it should be sufficient after settlement of account to inform the bank about renewal of the contract. Future profit or loss has no connections with past profit or loss in the case of a renewed contract.

5 At the end of each quarter every depositor will be informed about his profit or loss. He will have the right to dissolve the contract and withdraw his money settling his profit or loss account, or he may receive the instalment of profit and agree that this distribution of profit is tentative and in future, if there is a loss, it may be adjusted against this profit.

6 The depositor can demand his money whenever he likes. But for the account of profit and loss he must wait till the end of the current quarter unless the bank agrees that the preceding quarterly account can be made the basis for clearing the account. The money in *muḍāraba* account can be neither drawn upon nor

transferred to other persons through cheques. To withdraw the deposit, notice should be given of the intention to do so — unless the bank has waived its right to appropriate notice in any particular case. Money may be deposited in a *muḍāraba* account without fixing a time-limit and/or for a fixed term, for example, three or six months, etc.

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shareholder is not possible, unless the result of the completed business is known. It will not be legitimate to make a mere guess.

The period of one quarter is of no importance in itself — a shorter or longer period might be suggested. But certain considerations should be borne in mind when deciding on the period. The business party who gets capital from the bank on *muḍāraba* basis must be satisfied that while using the capital in business over a certain period he is getting its benefits. A factory owner may need to purchase raw materials with capital and will need a few months perhaps before he can sell his finished goods. How long such a period is will, of course, vary with the different needs of different factories or commercial organisations. The policy of the bank should be to see to it that every kind of business organisation gets working capital according to its needs at different times. On the other hand depositors and savers who keep their savings in *muḍāraba* accounts will not want their money to be tied up for long periods but prefer speedy returns. If the period over which profit for the depositors is computed is too long this will affect the supply of capital through *muḍāraba* accounts. The bank should then keep in mind both depositors' needs and the needs of business.

A quarter is neither too short nor too long. It does not follow that at the end of each quarter the bank will demand back its capital from business concerns; but the bank will need to see the accounts in which its capital is committed. Capital may be advanced for several quarters, in fact capital will normally be advanced for an undetermined period. The progress of the account will be looked at quarterly, and the capital will be drawn back when bank and the business party, or either one of them wish, in view of their own interests, to do away with the contract. And likewise, savings and capital from depositors will be handled for an undetermined period. At the end of each quarter after the preparation of account, the determination and distribution of profits or loss will continue. But most of the amount will remain deposited in the *muḍāraba* account. The depositor will withdraw the amount whenever he wishes to use it for some other profitable purpose or for some personal expense. As for such withdrawals from *muḍāraba* account, these will have little effect on the bank's business. At the end of each quarter withdrawals from some *muḍāraba* accounts will be made up by deposits in others, or in the same accounts in the following quarter. This means that,

except on some extraordinary occasion, there will seldom be strain on the bank to meet withdrawal demands. The bank may demand back its capital from business concerns, if it has to pay out to the *muḍāraba* depositors. It will be explained in more detail below that the bank's policy of advancing capital to the business party on *muḍāraba* basis and then demanding it back, will be a relatively free one, not too closely tied to the incomings and outgoings of the moneys in *muḍāraba* accounts.

It is advisable that the bank should keep a fixed percentage of *muḍāraba* accounts as Reserve, so that normal return of money to the depositors need not depend on the return of bank capital from business concerns. This objective can be achieved by keeping a small proportion, e.g. 3% or 5% as Reserve.

It is not compulsory that the quarterly periods of all banks should be concurrent. Every bank will be free to decide on which date its quarter should start. For example, one bank's date for depositing money in *muḍāraba* accounts may be the first day or first week of January, April, July and October and another bank may accept deposits at the beginning of February, May, August and November and so on. In this way working periods will be spread out over the whole banking system, so more facilities will be available to depositors and it will be possible for businessmen to get new capital at all times.

If by experience, some other period besides three months, say four or six months seems suitable, then that can be adopted. It is most probable that in the beginning different banks will clear accounts at different intervals. It will help ordinary savers, owners of large capital and business parties if one bank clears accounts quarterly, a second biannually and a third yearly. Some banks will specialise in making capital available for a long period on *muḍāraba* basis; others will advance capital for medium and short periods. In this way for all kinds of business needs capital will be readily provided. Practical experience, competition between the banks, and Central Bank guidelines, and the regulations that it will implement to meet general needs and protect public interest will be the basis for the smooth and effective running of the system.

Determination of Profit and Loss under *Muḍāraba* Account

In Chapter 2 we explained, with the help of an example, how a bank will calculate profit or loss on capital advanced to businessmen. Now we shall explain how it will divide profit or loss among its shareholders. To keep the discussion free of numerical complexity we shall assume that the income earned from the purchase of shares is included in the profit/loss under *muḍāraba*, and that the income earned from services is equal to the total administrative expenditure of the bank. In this way, practically only one mode of net income will be left, the profit earned on the capital used under *muḍāraba*.

The principle of determination and division of profit is the same as explained above. The total amount[1] of money deposited under the *muḍāraba* account including the total amount provided by the (founding) shareholders will be used in the business, i.e. for advancing to business parties on *muḍāraba* basis, for purchasing shares and rendering different services for the bank's clients. At the end of the quarter and the year the total profit earned will be divided over the total capital and the percentage rate of profit will be obtained. The total profit will be computed after adding the profit and loss which will occur as a result of the contract with individual business parties. In *muḍāraba* account an agreed proportion of profit will be added to each individual depositor's account. After distributing profit among *muḍāraba* creditors, the balance will be distributed among the shareholders proportionately according to their capital. If there is a loss, then the percentage of this total loss will be obtained. And a decrease equal to this percentage in the capital of each depositor and shareholder will be announced. It will be easier to understand the principle through a concrete example.

Suppose ten shareholders set up a bank with Rs. one million, contributing Rs. 100,000 each. In the *muḍāraba* account 10,000 depositors have put in an average Rs.500 making a total of Rs. 5

[1]If a fixed portion of *muḍāraba* account is placed as reserve it should also be considered included in its business. Except for this reserve the whole amount will be provided to the entrepreneurs. But the profit accrued on this amount will be spread over the whole number of accounts including the reserve to determine the percentage of profit.

million. The bank will receive one-quarter of the profit and the balance of three-quarters will go to depositors.

The bank advances this total capital of Rs. 6 million to different businessmen for the period of one year, on the condition that they will pay the bank half of the profit earned on this capital, and keep half as payment for their services. At the end of the year, the accounts are prepared in each business concern, and it is found that some have made a loss, others a profit. In some businesses it is more and in others it is less. The result of this addition of the total sum of loss and profit may be that (1) there has been overall profit; (2) an overall loss; or (3) the bank has broken even. Now, we shall explain the working out of results of these three separately.

Firstly, let us suppose that the bank made Rs.300,000 profit overall from those business parties to whom it provided the capital.[1] The profit of Rs.300,000 on capital of Rs. 6 million means that the rate of profit is 5%. The bank's creditors, according to the contract will receive Rs.3.75 as profit on each Rs.100, the balance Rs.1.25 on each Rs.100 will go to the bank as its share of profit. Each creditor who has deposited Rs.500 will receive 18.75 as profit. The balance of profit, that is Rs.112,500, will be the total profit of the partnership and will be divided equally among the shareholders. Each shareholder will receive Rs.11,250 as profit on his capital of Rs.100,000.

Secondly, assuming the bank makes an overall loss of Rs.300,00[2] i.e. it will receive back only Rs.5.7 million out of Rs.6 million which it advanced on *muḍāraba* basis. The rate of loss is 5%, each depositor will bear the decrease of 5% in his money. The depositor, who has deposited Rs.500 would now receive Rs.475 and in the same way each shareholder will bear 5% loss. The share of Rs.100,000 of each shareholder will be reduced to Rs.95,000.

Lastly, the bank has broken even because the losses of some

[1]For example: some business parties made profit of Rs. 800,000 total and there is a net loss of Rs. 100,000 on part of some. In this case, the bank received a net profit of 400,000 as its share in the profit and had to suffer a loss amounting to Rs. 100,000. The net profit of the bank stood at Rs. 300,000.

[2]For which various causes are possible. For example the total profit of the successful partners is Rs. 400,000 out of which the bank would receive Rs. 200,000 or half thereof. But some partners suffered a loss which amounts to a total of Rs. 500,000. The bank has thus suffered a total loss amounting to Rs. 300,000.

businessmen have neutralised the profits of others. Neither depositors nor shareholders will suffer a loss nor receive any profit.

From these examples it will be seen that, in loss, the *muḍāraba* depositor and the shareholders are injured at an equal rate. But in profit, the rate for the shareholder is more than that for the depositors. The reason for this difference is that the shareholders get full shares in the profit on their own capital and, besides this, a share in profit earned from the capital of *muḍāraba* account, while the *muḍāraba* depositors do not get full share of the profit earned by their capital. But they get a portion, i.e. (in this case) three-quarters of the profit. The justification for this is that the shareholders run the business of banking – they use their business abilities, experience, and effort to make the capital work to earn the profit. The depositors in *muḍāraba* accounts only provide the money and do not participate in the bank's actual business organisation, administration or services. Decisions about dealing in shares, the selection of successful, capable and suitable business parties for using capital on the principles of *muḍāraba*, are important activities which the shareholders themselves render or for which they employ paid experts. The share of profit which they get out of the money coming into *muḍāraba* accounts, directly flows from these business activities. The shareholders, moreover, run a greater risk than *muḍāraba* account-holders: in the case of loss the *muḍāraba* account-holders lose a part of their capital while the shareholders incur double loss in the form of loss in capital and deprivation of the expected gains from business. Although the possibility of loss and business results are uncertain the labour these shareholders put into the bank is just and proper and they should get more profit than the *muḍāraba* account-holders.

Use of Loans in Bank Business

In order to expand and promote business, banks may raise extra money by taking out loans from the public. The problem is how profit or loss are to be divided when the loans (the extra money) is used as working capital (along with the shareholders' share-

capital and the deposits of the *muḍāraba* account-holders). In fact the same principle should be applied as before. After the deduction of the profit for the *muḍāraba* account, and deduction of the profit for the share capital, the remainder (for the loan money) must be divided among the shareholders, for it is they alone who take responsibility for its repayment. The loan capital itself does not generate any profit for the lenders because the only responsibility of the shareholders attached to the loan capital is that it is to be paid back. If the business suffers an overall loss, that loss will be distributed over the total of the share-capital, the *muḍāraba* deposits and the loan capital; after working out the loss on *muḍāraba* account capital, the balance should be borne exclusively by the shareholders, because repayment of the loan is essential in profit or loss, and that responsibility lies with the shareholders alone. The *muḍāraba* account-holders have no concern whatsoever with it.

Let us suppose that the *muḍāraba* account comprises Rs. 4 million and the share-capital is Rs. 1 million and another Rs. 1 million has been obtained through loans. Out of a total profit of Rs.300,000, the account-holders will get Rs.150,000 on their capital of 4 million with the remaining profit of Rs.150,000 going to the shareholders; and out of the entire capital of Rs. 6 million which has come back after the completion of the business, Rs. 4 million would be given to the account-holders, Rs. 1 million would go to the bank in the account of the shareholders and Rs.1 million will be returned to the lenders. In this case the shareholders get more profit than they would have got if the loan money had not been working in the business. As shareholders they are entitled to the entire profit earned on the loan money secured at their own risk and responsibility, and the account-holders have no share in it since they did not share any responsibility for its repayment.

If the total loss suffered by the business comes to Rs.300,000 and out of the total capital of Rs. 6 million only Rs. 5.7 million returns to the bank after completion of the business, the account-holders would suffer a loss of 5%, i.e. they would get 3.8 million instead of Rs. 4 million; out of the remaining Rs. 1.9 million 1.0 million would go to the lenders and the share capital would be reduced to 0.9 million from 1 million thus suffering a reduction of

10%. Again this loss is more than they would have suffered if loan money had not been working in the business for the simple reason that the shareholders are solely responsible for the loan borrowed by them whether the bank earns profit or suffers a loss. This loss has a bigger percentage than the account-holder's loss because they are not responsible for repayment of the loan.

It is clear from the above instances that when loan money is included in the business the bank in case of profit earns a higher amount of profit and in case of loss suffers a higher loss. The bigger the amount of loan money the higher percentage of loss the bank risks. It is quite natural that cases will crop up where the shareholders have to collect more money (in addition to their share capital) to discharge their liabilities towards the lenders. Opposed to the high risks the profits that accrue to the shareholders through working the loan would also be higher.

The Loan Account

The bank invites the public to loan its money for security and for convenience when making payments, and it accepts the responsibility for repaying the loan on demand. Persons depositing amounts in the loan account have the right to draw cheques and even to transfer money in favour of other account holders. The bank does not charge anything for these facilities. The loan account would be operated as current accounts and demand deposits operate in modern banks and would have the same facilities as are normally available to holders of current accounts.

Depositors in the loan account would have the guarantee that their money must be returned on demand. This guarantee would be endorsed by the national Central Bank which will make these guarantees dependable by making the cash position of these banks sound and through an insurance scheme for the different accounts.

As long as the money remains in a loan account, the bank will have full control over it and be at liberty to invest it profitably. If the bank suffers any loss in transaction with the loan capital the loss must be borne by the bank itself and the account holder remains entitled to the return of the amount in full. Similarly, if the

bank earns profit out of it, the profit will go to the bank and the account holders will have no share in it, being entitled only to the actual amount deposited.

Usually people do not spend their income all at once but slowly and gradually and in the meantime deposit the surplus in a current account. In the proposed non-interest system these amounts will go to the account which resembles the present demand deposits. Moreover, those persons will also deposit their savings in this account who do not want to take the risk of loss by depositing in *muḍāraba* account but wish to make their savings secure. It is also proposed in the following pages that the bank should reciprocate the receipt of loans without interest by issuing loans without interest. In the proposed system the issue of loans without interest will depend upon people depositing with confidence in the bank's loan accounts. This should persuade people with a sense of the public good to deposit their savings in the bank instead of hoarding.

The question naturally arises of how the bank will meet the expense of maintaining the loan accounts and arranging for their security. The answer is simple – these expenses will be adequately met out of the profits expected from investment of some loan deposits in profitable business.

Experience of modern banking shows that the deposits in the current account (demand deposits) are generally much more than in long-term deposits and savings accounts.[1] A similar position is expected in the case of loan deposits and *muḍāraba* deposits. As suggested above, some deposits which are nowadays in long-term deposit accounts will be deposited in the loan account rather than *muḍāraba* account. For further discussion let us assume that the ratio between the two deposits is 3:2. The commercial banks find it possible to keep a fraction of demand deposits in reserve and still be able to make payments out of the remaining deposits because all the account holders do not demand repayment simultaneously.

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[1]See Redcliffe Committee's Report on the Monetary System, August, 1955, London (Her Majesty's Stationery Office), p. 43. In 1958 the total amount in current accounts in the banks in the U.K. was 60% and that of fixed deposits was 40%. The banks do not pay interest on the current accounts. In the United States of America also there is the same proportion between these two accounts. See Whittley, Charles R. and others: *Money and Banking*, Macmillan: New York, 1963, p. 120.

The same practice will be adopted in the proposed loan account which means that after reserving a percentage of the deposits the remaining account will remain in transaction.

The proportion of reserve against demand deposits is greater than that against long-term deposits because in the latter case it is necessary to give a few days' notice of intent to withdraw; however, in spite of this, in actual practice there is hardly any distinction between the two accounts in the banks in England and some other countries.[1] On the other hand they keep a specific percentage of their total deposits in all accounts reserved in cash. For convenience we have presumed that the banks keep reserves to the extent of 10% of the deposits in loan account and *muḍāraba* account. Assuming an equal proportion of reserve against both the accounts will not affect the results of our discussions; assuming separate reserve ratios against each account will merely introduce unnecessary and unfruitful complications in the numerical examples that are given.

It is a popular practice of banks not to distribute all the profit earned on the share capital among the shareholders but to keep a portion of it in reserve. Reserve funds of different kinds are created, the most important function of which is to off-set any threatened collapse of the business and to protect the share capital of the shareholders. This practice will be available in a non-interest system. However, justice demands that a shareholder be given a proportionate amount from the reserve profit when he withdraws his share from the bank.

Is it right to arrange to make up losses from the profits reserved from profits earned against *muḍāraba* account, so that the capital does not suffer reduction? It is right, provided that A's loss is not made up from B's profits. It should be clearly known what amount of profit for a particular account holder has been included in the reserve profits and only the loss suffered by that account holder should be adjusted against reserve profits while closing his

[1] D. H. Robertson: *Money*, Cambridge, 1956, p. 69. If the situation in all the countries of the world is studied half of them keep a reserve in the same proportion for the two accounts. In the remaining countries these proportions are different. But in modern times there is a general tendency to keep these ratios similar. See Peter G. Fousek, *Foreign Central Banking*, Federal Reserve Bank of New York, 1956, p. 47.

accounts. He should be allowed not only the profits of the current year but also the amount of profit for his account in the reserves – assuming it was not utilised in making up any loss suffered by his account. The main advantage of adopting this practice in respect of *muḍāraba* account holders is that in case of loss in the business, the bank would not need to show the loss in the deposit of any account holder – except those who are closing down their accounts and whose reserve profits are not sufficient to meet the loss.

In adopting the above practice and to meet the aims of justice, the task of maintaining the account would become very heavy, entailing colossal expenses. In view of this difficulty another solution worth considering is that every account holder agree, in a spirit of mutual co-operation, to forego a portion of his profit in order to help one and all when affected by loss. In such a case the 'reserve fund' created out of the profit would belong to the bank and if at any time the bank decided to wind up the business, the amount in the reserve fund could be distributed among the shareholders.

This system is workable and will certainly be adopted in actual practice. Further discussion of the question of reserves will concentrate on only those reserves made up of a specific percentage of the *muḍāraba* and the loan account, and maintained in order to meet withdrawal demands. The 'reserve fund' made up by reserving a portion of the earned profits in order to off-set losses is a separate matter and of no significant relevance to the discussion following.

Competition among Banks

Every bank will not only try to maintain goodwill but be anxious to earn more profit and business. The success of the bank will mainly depend upon selecting sound business parties with whom to invest the bank's capital, to yield greater profit on the *muḍāraba* account and at the least risk of loss. At the same time it is also important that maximum capital is deposited in the *muḍāraba* and loan accounts. The more deposits a bank gets, the greater its opportunity to diversify its capital investment. In investing capital, the selection of different parties and of many

different industries and in different areas, over different time periods, reduces the possibilities of losses but this is only possible with a large capital,

Savings holders and moneyed people will keep an eye on the rate of profit that the bank has actually been distributing to its *muḍāraba* account holders. A bank which saves its account holders from suffering losses and offers them the highest rate of profit will be able to attract a greater number of people anxious to deposit savings. And this creates an area of competition among the banks as each tries its best to avoid going into loss and to earn greater profits. Another area in which the banks will compete with each other is in offering the most efficient services with the lowest charges. In a non-interest system this competition between banks would necessarily create efficiency.

In modern economies the growing importance of financial intermediaries that can give people diverse facilities for use of their savings (such as Provident Fund Schemes, Insurance Companies, Housing Societies, etc.) is everywhere evident. The banks must compete with these institutions also and success in the field will lie in extending the range of services offered either free of charge or at nominal charges.

CHAPTER 4

Bank Loans

The bank will advance short-term loans to business parties and not receive remuneration for this service. However, it will render this service only to an extent precisely calculated, determined as a proportion of the capital deposited in the bank's loan accounts. The borrower will have to guarantee repayment of the loan within the scheduled period.

Although the bank will not be able to receive interest on the loans it issues nor any remuneration from borrowers, society will benefit from such an important service and the bank will be rewarded indirectly. The bank will be allowed to invest the remaining capital in its loan accounts in other profitable economic activities. It should now be clear that the banks will not have to pay any interest on their deposits.

The people who deposit their capital and savings in the banks will be able to draw any amount whenever they want. But long experience of banking shows that a sizeable part of deposits in current accounts is not withdrawn. On any particular day or over a week a very small fraction of these deposits, say one-tenth, is demanded back. But on the same day and every week additional sums of money are being deposited in the bank's accounts. The account holders go on changing but a major portion of their total deposits remain with the banks.[1] If the bank arranges to keep a small fraction of the total amounts of its loan accounts, say one-tenth or one-twentieth, as a reserve, it becomes easily possible for it to pay for the daily withdrawals from the loan accounts out of this reserve, and the daily deposits. The remaining portion of the

[1]'The number of individual accounts are increasing and decreasing and the account holders also keep changing but the existing amount of current accounts remains constant.' Radcliffe Committee Report, p. 43.

loan accounts can be utilised by the banks. In the contemporary banking system this remaining portion of the current account is used for making very short-term loans and thus becomes a source of income for the banks. In the interest-free system a part of this remaining portion will be used by the bank to advance interest-free loans, and the other part will be used to earn profit by investing it on *muḍāraba*. No part of this profit will be disbursed among the account holders. It is our estimation that the rate of profit earned on this capital will be higher than what present-day banks earn as interest on on-call or other very short-term loans. Therefore, if the assumption is valid that greater amounts will be deposited in the loan accounts of the interest-free banks,[1] there is no reason why the income accruing from the profitable use of a part thereof should be less than what the existing banks earn from it by lending on interest. Apart from this supplementary point the important issue for the topic under discussion is that the right to utilise a part of the loan (current) account depends upon the fact that the other part of it is used to advance interest-free loans.

As will be elucidated in the discussion on the Central Bank, the commercial banks will also become entitled to draw interest-free loans from the Central Bank as needed.

Our suggestion is that the commercial banks should be given loans by the Central Bank in a fixed proportion to their advances. The banks will have to present documents or certificates as security against their advances to draw loans from the Central Bank, which will neither charge interest nor demand any other remuneration.

After this brief statement of the subject it seems necessary to discuss certain aspects in detail. Since it is a new proposition for students of modern economics and experts on the modern banking system, it is necessary to focus their attention on all its aspects so as to establish its validity and practical usefulness. In the following paragraphs we shall, therefore, discuss some of the issues

[1] As explained above, we think that in interest-free banking some of those amounts will also be deposited in loan accounts which are normally deposited in long-term deposits in present-day banks. There will be amounts which are owned by people who, although they do not want to use them for a considerable period, yet do not want to risk loss by keeping them in the *muḍāraba* account. If this idea is correct, more money will be deposited in the current accounts of the proposed banks than in contemporary banks.

individually:

(a) Importance of short-term loans for entrepreneurs; possible ways and means for their procurement in an interest-free economy.

(b) The possibilities of meeting this need out of loan accounts.

(c) Incentives for the banks to advance interest-free loans.

(d) Demarcation of the limits or ratio for advancing interest-free loans out of loan accounts.

(e) Guarantees for the repayment of loans.

(f) Principles for the determination of the periods of the loans.

(g) Decisions about beneficiaries of such loans.

(h) The question of operating expenses on the administration of loan advances.

A. The Need for Provision of Short-Term Loans

Very often entrepreneurs need short-term financial assistance. Such a need may arise in every type of enterprise, whether industrial or commercial or agricultural. But in an industrial enterprise such needs arise during the process of production. The entrepreneur will need additional finances for a few days or a few weeks which he expects to return with the income he anticipates from the sale of his products. Traders who want to sell imported products on the market may need finances for the period between imports and final disposal of goods on the market: they may need them to make unavoidable payments or to meet expenses involved in carrying the goods to market and sale. In the modern economic system this need is met by short-term loans advanced by the commercial banks. These loans are advanced on the pledge to return on-call for one day, a few days or a few weeks, and interest is to be paid at a given rate.

The problem of such short-term loans cannot be solved by the system of partnership or *muḍāraba*.

The first reason for this is that it is difficult to keep an account of loss and profit on capital invested for such a short period. Secondly, no entrepreneur is likely to be willing to forego a part of his profit at the final stage of his business activity, a profit he thinks to be solely his, by entering into a partnership with someone who

can provide some finances at this stage. Moreover, if a loss is feared towards the final stage of the business, the entrepreneurs will not be able to procure any capital from the capitalist on the basis of partnership.

It is also no solution of the problem that entrepreneurs should from the beginning hold some capital in reserve for such short-term needs. If they keep a portion of their total capital unutilised for a long time so as to meet their needs towards the end of the process of production, their business will be reduced to the extent of such reserve capital. Moreover, if such a solution is adopted throughout the economy, it will reduce the overall volume of business and slow down the progress of economic development. For the proper development of the economy and for the progress of its businesses only that solution is appropriate which can meet temporary needs for capital in a way that does not reduce long-term investment capacity. This can be done only through credit or bank loans, for such credit is as temporary as the needs it is created to meet.

When an entrepreneur gets a loan from the bank, the bank creates new capital equivalent to the loan advanced to him.[1] The entrepreneur meets his requirements with this money. After completion of the processes of production, disposal of the product and repayment of the loan to the bank, its capital is reduced to the extent of that repayment. In this way, capital temporarily created performs a very important social service. Namely, the services operating in the production of goods are rewarded, even prior to the sale of the products to the consumers and return of the proceeds to the producer.

In modern interest-charging economies short-term capital is provided through loans in a similar fashion. The fact that the banks charge interest does not change the fact that these loans take the form of bank money created temporarily for this purpose and becomes non-existent automatically with the return of bank loans. In our proposed system it will be of a similar nature. It does not affect the nature of the bank money or the social function of the

[1] At this stage it will be worthwhile to consult some appropriate sources for the study of the process of credit generation, its temporary nature or its usefulness as a social service. For example, D. H. Robertson: *Money*, Cambridge, 1956. Ch. V.

short-term loans whether the economy is based upon interest or profit-sharing.

B Short-Term Loans

As we have explained above, if the banks retain a fixed proportion of demand deposits, say one-tenth, as reserve, they will be able to meet all withdrawals out of this cash reserve and the new day-by-day deposits. It actually depends upon the habits of the public. In modern societies people usually keep their savings in banks rather than keeping them themselves. Moreover, they keep only a small portion of their income in cash in order to meet sundry daily requirements and keep the main part of it in current accounts in banks. Obviously they make their major payments through cheques, a convenience both for them and for those who receive these payments. Most of these recipients, especially businessmen, salaried employees and experts in different fields, deposit these cheques in their current accounts, and adopt the same method of paying through cheques. Because of this habit a large part of the total income of the society remains in the current accounts of the banks and only a small portion remains with the public in the form of cash money. Most payments are made through cheques. Very often the cheques are not encashed, rather the recipients of cheques deposit them in their own account. The people who demand cash for their cheques do so from their own accounts and have to make small payments. This common habit is the basis of banking and, because of it, it has become possible to have such a huge supply of money, far greater than the total amount of cash in the society. Only a small fraction, say one-tenth, may be found in the form of cash whereas nine-tenths exists in the form of bank money.

It is on the security of this general habit that the bank reserves a small fraction of the amounts deposited with it, for instance one-tenth, and considers the major portion thereof as usable and does use it. In the contemporary banking system this usage of the money is always in the form of loans advanced on interest. Our proposal is that in an interest-free economy, a portion of the balance should be invested on the principles of *muḍāraba* in a

profitable enterprise and another portion should be utilised in advancing interest-free short-term loans.

The portion of the above amount advanced to the entrepreneurs on *muḍaraba* will be deposited back in the banks, for the entrepreneurs also have the same habit of depositing their money in the banks, and make most of their payments, e.g. for cost of raw material and salaries and rent of the building occupied for the business, through cheques. In order to make use of the money transfer facilities through cheques, they deposit their money in current accounts, that is, in the loan accounts in the proposed interest-free system (as explained in the last chapter). In the same way out of that part of the loan account lent to the entrepreneurs for a short period, the major portion will again be deposited in some bank, the more so as more or less these amounts will also be used by the entrepreneurs for the type of payments mentioned above.

If this process is further extended it will be observed that the persons to whom the entrepreneurs will make the payments out of the loans advanced to them, e.g. owners of the buildings, salaried employees, suppliers of raw material and semi-finished goods, artisans and labourers – will in turn deposit the same in the banks according to the general habit.

In this chapter we are not concerned with the process of creation of credit and its continuance in interest-free banking. This has been dealt with in the next chapter. We only indicate here that according to the proposed method the bank will be able to utilise the major portion of its deposits for advancing loans and investment on the basis of *muḍāraba*. This use will itself become a source for receipt of additional money into its accounts, and this process will be extended in the same way as in the conventional banking system. We might also argue for the proposed system in view of the demands of the business class and the importance for them of obtaining capital. Some of the problems related to this will be discussed in the next chapters. But there is no doubt that this need can be fulfilled in this way.

C Incentives for Advancing Interest-Free Loans

Now we will explain the correctness of this method as a practical solution of the problem, that by providing real incentives for the banks to advance interest-free loans, a great social service is rendered. As has been indicated above, a regulation will be issued by the Central Bank under which all banks will be obliged to assign, say 50% of the deposits in loan accounts to advancing loans. If they do so they will be entitled to invest 40% of these deposits in profitable enterprises (the remaining 10%, we are assuming, the banks will hold in cash reserve). Any banks not prepared to advance interest-free loans will not be allowed the privilege of opening loan accounts and obtaining the savings and capital from the public on an interest-free basis. The public's savings and capital may be held in the form of loans only by those banks willing to advance interest-free loans to the people, to the extent of 50% of the above capital.

This regulation will be the first and, in our opinion, a very strong incentive to banks to issue interest-free loans. The banks will attach so much importance to the profit-earning use of the portion of the total capital set aside for investment in profitable enterprise (40% of the total in the instance given above) that they will be willing to issue interest-free loans from that portion of the total set aside for that purpose. Thus, the procurement of interest-free capital will not result in a loss if it is used to make interest-free loans, especially as these loans will, necessarily, be repaid to the banks. It will be discussed in detail in the following paragraphs how the whole economic system will be organised in such a way that the banks must necessarily get back loans they issue. As against issuing loans the bank will have the benefit of a huge amount of capital for investment in profitable enterprises on the basis of *muḍāraba*.

Undoubtedly, in an investment of capital in an interest-free enterprise there is the risk of loss. As the banks will have to repay deposits to account holders on demand, they will inevitably and necessarily be very cautious before taking risks. The practical reality is not that banks will hold on to capital, leaving it unutilised due to their inherent entitlement. A more realistic outcome is that

banks will utilise the capital but in relatively safe enterprises, even though their rate of profit may be lower. One instance of a profitable enterprise is the organisation of paid services which the bank itself undertakes. The banks will have no difficulty in choosing institutions in which they have the fullest confidence – so as to minimise risks of loss, and in the light of past experiences of raising capital for them on *muḍāraba* basis.

In the preceding chapter it was established that the banks will get a huge amount of capital, on *muḍāraba* from the account holder, and on the basis of partnership from the shareholders. A portion of the capital received from the loan account holders will be utilised along with the capital received on the basis of *muḍāraba* and partnership, for investment in profitable enterprises. It is hoped that the banks will become so expert in the selection of suitable parties for making investment on *muḍāraba* that a loss in such business will be extremely unusual.

Quite apart from the results of the bank's transactions as a whole, the prospect of making profitable use of a huge amount of capital, on the condition that no part of the profit earned will be payable to the owners of the capital, is of itself very attractive and will be a great incentive to banks to willingly offer loans from the non-profit making portion of deposits in loan accounts.

The Central Bank will give an undertaking to commercial banks to give them loans as needed, without interest and without any remuneration of any sort. The quantity of loans made available to them will, however, depend upon the quantity of loans they themselves offer. Only those banks which have given interest-free loans may draw loans from the Central Bank. The Central Bank will offer loans amounting to 10% or 20% of the loans advanced by the commercial bank. The bank will use such a loan to meet its cash demands, to maintain liquidity, when repayments are demanded of it. Public confidence in the bank's ability to meet repayment demands invariably, and on time, whether for loan or *muḍāraba* accounts, is of the utmost importance for the success of any bank. Normally the bank will hold sufficient cash in reserve, and arrive at such agreements regarding repayments of the loans advanced to the entrepreneurs and other individuals, that it should encounter no difficulty in meeting cash demands. But as market

trends and people's cash needs are always changing, such a situation may arise. Obviously, the convenience of Central Bank loans to meet such a crisis is a blessing for which the commercial banks will have a very high regard, and provision of this facility will prove to be a sterling incentive to them to offer interest-free loans. (A detailed discussion is given in the next chapter on the role of the Central Bank.)

The third great incentive is public image, the bank's desire to maintain cordial relations with entrepreneur clients and to raise its prestige in the eyes of account holders and the public in general. The idea that by offering interest-free loans the banks are rendering an important social service will inspire people to consider banks an important social service agency rather than a purely commercial institution anxious for its own profit. The people's good faith and confidence is vital in the setting-up and successful operation of the banking system. Thus, in order to win public confidence and support, the banks will undertake the social duty of advancing timely (interest-free) loans, a duty which can, in practice, be discharged by them without any loss.

It cannot be over-emphasised how individuals and institutions who receive loans will be obliged to the banks and will maintain cordial relations with them. The banks may expect them to become account holders or customers, and when need be will offer them the bank's charged services. If we analyse the attitudes and general thinking of those to whom the bank will issue loans, it will be seen what benefits the banks can expect to derive from doing so.

Loans will mostly be to entrepreneurs, as we have already noted, a great majority of whom may be running their business on capital from the bank on *muḍāraba*. The short-term loan will thus benefit the bank too, for in helping the entrepreneur to run his business or to expand, the bank will be helping a business in which it has a share, in whose increased success and profit it will share according to the ratio of profit-division agreed in the *muḍāraba* contract.

Since, as was made clear above, in accounting for the bank's profit, short-term loans are not counted in with the profit of the business, the bank will undoubtedly earn profit by giving loans to its partners, and such profit will be a major incentive to do so.

Reciprocally, the individuals and institutions who take out short-term interest-free loans from a particular bank as and when needed will wish to expand their business through the same bank and will open their accounts with it in order to harmonise further mutual relations. Since all individuals and institutions open bank accounts (to make withdrawals as needed or to deposit surplus) and issue cheques to meet their daily needs, it is only natural that they should wish to have their accounts with that bank from which they expect to get overdrafts and long-term loans.

A bank may well advance loans to individuals and institutions with whom it does not have an agreement on *muḍāraba* or partnership. In practice, even if such individuals or institutions do not have an agreement with the bank advancing the loan they will have one with some other bank. Keeping in view the interest of all the banks, it is immaterial if someone obtains *muḍāraba* capital from one bank and the loan from another. Advancement of loans to its business parties will promote the common interests of the banks and once more prove a major incentive.

Whether the bank will advance loans to the Government and to consumers besides loans to entrepreneurs, deserves detailed and separate consideration. For the present, we would state briefly that the banks will do well to issue interest-free loans to those individuals or institutions who have current (loan) accounts with them. Such loans will to a large extent have the character of overdrafts and amounts credited against existing accounts. Thus the bank will extend to its account holders such facilities as will encourage deposits even in loan accounts; the bank's own interest requires that it wins the confidence, goodwill and sympathies of its account holders by making payments or withdrawals of amounts over and above the actual deposits.

To sum up then: the three major incentives for running interest-free loans are the procurement of a huge amount of capital for investment in profitable enterprise; obtaining interest-free loans from the Central Bank for the maintenance of liquidity; and the goodwill and confidence of the business community and of the public in general.

D Determination of the Ratio between Loan Account and Loans to be Advanced

This question can be properly answered only in the light of practical experience in interest-free banking. The needs of businessmen, the business interests of the banks themselves and general considerations about the economy as a whole must be kept in mind: the purpose of fixing the ratio is to ensure that the economy overall runs smoothly and successfully. The figure decided upon should not be so small that the critical needs of business are not met in time – if this happens, as we pointed out above, business would be obliged to hold back a part of its capital which would otherwise be invested on a long-term basis to meet temporary needs and overall economic activity would be reduced. Nor should the ratio be so great that after setting aside its cash reserve, the bank has so little to invest in profitable enterprises that it may consider either loan accounts or the giving of loans not worth its while. The projected system will work successfully only when the incentives for giving interest-free loans are strong and dependable.

In our view, a ratio might be fixed at the very outset, in consultation with banking experts and representatives of the business class, to be modified later in the light of practical experience and with the general objective of the economy's overall success always in mind. We shall expand upon this subsequently. The Central Bank may change the ratio as and when it sees fit. We shall suggest here a ratio of 50% just as a working example, and hereafter this will be called the 'lending ratio'.

E Equilibrium between the Demand for and the Supply of Loans

The total supply of loans to be advanced by the banks will depend upon the total deposits in their loan accounts. According to our suggested lending ratio the loans supplied will be equivalent to half of the loan accounts. The Central Bank can, by making suitable changes in the lending ratio increase or decrease the supply of loans. The demand for loans will depend largely upon

the level of long-term investment. Short-term capital will be required only to meet the urgent and temporary needs of a business, needs that ultimately depend upon the quantity of capital on which the business is being run. It will not be difficult for the Central Bank, through an economic survey and practical experience as well as statistics to make a balanced estimate of the loan needs of the business community at any particular time. This estimate will help the Central Bank, when it fixes or changes lending ratio (when it increases or decreases capital and credit flow in the economy), to establish a harmony between the supply and demand of loans.

In the movement of capital available for short-term interest-free loans to entrepreneurs who ask for them, the wider interests of the economy and profitable investment of loan capital should be given priority. The need to fix priorities may arise due to an unexpectedly high demand for loans comparative to supply. In these circumstances the size of the long-term capital invested by any entrepreneur in his business might be kept in view for the assessment of his loan needs. It can be ascertained from an economic survey and a study of the relevant statistics what loans for what periods may be required in certain industries at certain times. It would be wise if, instead of leaving the above assessment to individual banks, representatives of entrepreneurs and experts in economics would form a committee under the supervision of the Central Bank, and apply themselves to the task.

While considering any particular case, the bank must have power to find out from the applicant all details regarding the status of his business (e.g. what amount of long-term capital has already been invested, and what amount of loan has already been procured from other resources). The bank may also conduct investigations into the capacity of the entrepreneur and his loan needs. One of the criteria for according priorities to applicants demanding loans might be the status of the securities offered against the loans. There should also be a standard minimum of securities which the applicant must offer against the loan. The banks should also have power to accord priority to those entrepreneurs whose securities are more reliable as compared to others, or those with whom it may have signed an agreement on

the basis of partnership or *muḍāraba*. In order to prevent the danger of misuse of bank powers, the danger of discrimination against certain entrepreneurs, some regulations must be framed. In some cases the applicants deprived of loans should have the opportunity to submit appeals against any discrimination, so that banks found guilty of breach of the rules can be penalised.

It is conceivable that sometimes so many viable applications for loans will be received that the bank cannot meet the demand. In such circumstances, the principle of first come first served should be operated until the bank's funds set aside for issuing loans are exhausted.

If it happens that loan applicants fail to get a loan from any bank the Central Bank may consider expanding credit by adjusting the lending ratio accordingly.

The problem of proper distribution of the interest-free loans funds, of harmonising demand and supply, is one that merits active consideration before and during the operation of an interest-free banking system: practical experience will require and enable adjustments and innovation in methods and procedures.

F Duration of Loans

While discussing the issue of short-term loans for entrepreneurs we have already indicated that it is impracticable to obtain short-term capital on the basis of *muḍāraba* because of the accounting difficulties involved. It is then obligatory that a maximum term for such loans be stipulated. We suggest that this should be somewhat shorter than the term for which banks supply capital on *muḍāraba*, namely, as we suggested above, a quarter or 13 weeks. Those requiring loans for three months or more should acquire them on *muḍāraba*. When their business requirements can be satisfied through capital advanced on a profit-sharing basis there is no justification for the provision (from the public's deposits) of interest-free loans.

If the minimum period for supplying capital on *muḍāraba* is 13 weeks, we suggest the maximum term for repayment of loans should be fixed at 10 weeks. It should, at the same time, be verified that no individual or institution is getting a loan for purposes that

might be served by capital obtained on the basis of *muḍāraba*. It follows automatically that it must not be possible to obtain a short-term interest-free loan and then renew the loan or replace the loan at the conclusion of each three-monthly period. The Central Bank will be required to investigate, control and supervise the activity of commercial banks in this regard and frame the necessary regulations.

As for a minimum term for loans, in fact none can be fixed. Some needs may be met by a loan for some hours or one day. In case of loans between banks, 24 hour loans are of considerable importance.

Those receiving loans are not required to pay interest, and so the length of the period of repayment will not feel like a financial burden to them, something that may encourage complacency and a tendency to unnecessarily postpone repayment. The public interest demands that this possibility is prevented: loans should be advanced only for such periods for which they are actually needed, and on completion of the term these loans must be repaid. Social awareness and a feeling for the public interest should be developed among businessmen so that they do not jeopardise the public good through unwarranted delay in repayment. At the same time the banks should have power to verify the need for the loan in order to determine the proper term for it and, on completion of the term the borrower must be obliged to repay. If practical experience justifies it, some penalty may be imposed on those who delay repayment. For instance, defaulting borrowers might be debarred from obtaining further loans for a specific length of time and/or their names notified to all concerned, which should seriously affect their prestige. Alternatively, fines may be imposed on them. The bank must not, however, regard such fines as income: these should be transferred to some department of the Central Bank and used in some social welfare work.

We may hope that the voluntary co-operation of businessmen conscious of the common interest and of other members of the public, will make it quite unnecessary to implement regulations of this kind. Their mere presence should be enough, to deter malpractice and encourage the business community to follow the path of right action.

G Sureties against Loans

As far as securities are concerned, more or less the same conditions will apply in the interest-free system as in the conventional interest-charging system. Finished or semi-finished goods, goods in process of production or in transit, ready crops, commercial shares, certificates of ownership, plant or immoveable properties, securities deposited in the banks, capital procured on loan or on *muḍāraba* etc. – all can be produced as security. The banks should have power to advance loans even on personal securities. Conventional contemporary banks advance a large number of loans even without security, because they trust certain individuals or institutions. In the proposed system the banks will be able to advance loans to individuals and institutions with whom they may have a current agreement on partnership or *muḍāraba* and in whom they have full confidence. In general, so much security should not be demanded as to impair the freedom of action of the business community.

Loans advanced by the banks must be repaid because they are responsible for the refund of all money deposited by their account holders in the loan accounts. Even if some loans are not repaid the bank's responsibility to loan accounts remains. In view of this, banks must have powers under the laws of the land to recover loans that remain unpaid by selling the properties produced as securities or the business's assets. The laws of every civilised country have procedures for the repayment of loans but, if the borrower becomes bankrupt, the lenders cannot in practice exercise this power. Such a situation may arise even in the proposed system: what then is the bank to do when the borrower has become bankrupt?

Clearly the bank must get back all the loans it advances; otherwise it cannot provide the public service of interest-free loans.

It would be against all justice to hold the bank responsible on the one hand for the refund of all money deposited in loan accounts and on the other, in case of non-recovery of loans advanced from those accounts, require the bank to sustain the loss. A society that desires banks to provide interest-free loans must also provide

necessary protection to the banks against non-repayment of such loans. It is obvious that if the borrower has become bankrupt, the bank has no way in practice of recovering the loan.

In these circumstances the only solution is that society should itself undertake the responsibility of repaying a part or all of such loans. In this connection we have proposed that in an Islamic society such loans should be repaid from the *zakāt* fund and the State should undertake the responsibility for their repayment. It will, however, be more practicable from the standpoint of the banking business that in case of non-recovery of loans due to bankruptcy, the Central Bank should cover the banks, having first conducted a thorough investigation to its entire satisfaction, and in any one year for total amount paid out by the Central Bank in this way, the Central Bank may be reimbursed by the State from the *Baitul-Māl* of *zakāt*.

This book cannot deal with *zakāt* or its uses in detail. Proper sources should be consulted: study will show, in fact, that the early Islamic State undertook the responsibility for repayment of unpaid loans, which is ultimately a demand of justice and fair play. Assistance for the repayment of loans is included in those eight uses of *zakāt* enunciated in the Qur'ān, namely, the amounts disbursed for financial assistance to those individuals or institutions who cannot repay their loans having become bankrupt, and who are legally entitled to this assistance.

H Expenses incurred on the Maintenance of the Loan Account

In order to scrutinise applications, make decisions, and maintain the accounts of the loans advanced, the bank will have to employ numerous salaried staff, and bear other related expenses. Naturally the question arises, how will these expenses be met? There are two answers:

The first is for the bank to use some part of the profit it earns from profitable use of loan accounts. This procedure may be adopted when the lending ratio is relatively low, and the major part of the loan account is being utilised in profitable enterprises. The snag here is that while the results of profitable use of loan accounts

are uncertain and unscheduled, the expenses to be met are both scheduled and certain.

The other alternative is that the banks should charge a fee for the service. An appropriate way of levying such a fee would be to require prospective borrowers to pay a fixed amount on each application, regardless of the amount required, the term of the loan or whether the application is granted or rejected. Then the applicants to whom a loan is granted may be required to pay an additional prescribed fee for all the entries made in the bank's registers. The criterion for fixing the fees must be the actual expenditure which the banks have incurred in scrutinising the applications and making decisions, and in maintaining accounts until loans are repaid. These fees should not be made a source of income for the banks, but regarded solely as a means of maintaining and managing interest-free loans. To keep within reasonable limits, the Central Bank should satisfy itself in this regard when auditing the accounts of the commercial banks to ensure that they have not made such fees a source of profit.

We recommend that the banks should be free to adopt either or both methods of meeting expenses. The banks should be free to both fix fees and collect them (within the condition that this does not become bank income). In this way the competition between banks will encourage them to offer the best service most cheaply in order to increase their own prestige and increase the number of their customers.

We may say in conclusion then, in the light of the above discussion, that the proposed system is practicable and convenient: that, while most needs for capital will be met from capital obtained on partnership or on *muḍāraba*, an interest-free banking system can also meet short-term needs with short-term loans.

I Problem of Bills of Exchange

A bill of exchange is a document between two persons in which one of them declares that he will make a payment for goods or services (from the other) on a certain date. Such bills are used both inside a country and for import-export transactions. We shall only deal with internal bills.

Let us suppose that a businessman has given a bill of exchange to a manufacturer or vendor for certain goods. The vendor can recover the amount indicated on the bill on the specified date. It often happens that the executor of the bill of exchange has an understanding with some bank that payment will be made at the prescribed time or the bank itself takes the responsibility for making the payment. In such cases the vendor presents the bill to the bank, at the proper time, for encashment. However, it is very seldom that the seller holds on to the bill of exchange till the specified time and then cashes it directly. If reliable securities are entered on the bill, he will obtain cash from some bank against this bill. A discount is, however, made from the bill at the time of its encashment at a fixed rate. This rate is generally equivalent to the current interest rate. When the bill becomes due the full amount of it is paid back to the bank, although less than that amount was paid out for it by the bank: the difference between the two amounts is the interest.

Supposing the bank has paid a sum of Rs.970 against a bill of exchange of the value of Rs.1,000 maturing after three months. Evidently the bank has recovered interest on the above amount at the rate of 12½% from the executor of the same. This too is ultimately a method of advancing short-term loans. The interests of the business class demand that it have facilities for encashment of bills of exchange so that its business may not be adversely affected by shortage of capital. In the above example the manufacturer pays the amount he owes on encashment of the bill of exchange, or makes alternative arrangements in order to continue the business.

Bills of exchange are becoming rare in the contemporary economy and are being replaced by short-term loans.[1] In an interest-free banking system too, businessmen may prefer that procedure. Instead of executing bills of exchange they may pay the vendor the cost of his goods in cash by taking out short-term *muḍāraba* funds. When their own product is sold they will repay to the banks the capital 'supplied' by them along with a percentage of the profit made from it. As such 'funds' are needed only for a

[1] R. S. Sayer: *Banking in Western Europe*, p. 243.

very short period, say a few weeks, it would be normal for the banks to accept a smaller share of profit than they would expect on funds supplied for a period of three months or more. If the businessman suffers a loss on the sale of his product, that loss will be borne by the bank; because of this risk of loss banks will be prepared to supply funds to the entrepreneurs at low ratios of profit-sharing for a short period only when the prospects of high profit are brighter and the risk of loss nominal.

In view of this aspect of the problem it is possible that the capital needs of some businessmen will not be met by *muḍāraba*. We will, therefore, indicate another method along with the procedure described above which is practically equivalent to obtaining a loan from the bank. In this way two means of meeting the same need will lead to convenience and expansion in the business.

In the proposed system the procedure for encashment of bills of exchange will be the same as that for obtaining loans from the banks. Banks will get requests for payments in cash against bills of exchange and these requests will be considered along with applications for loans. If the banks decide to encash the bills they must pay the whole amount entered and not make any deduction. The nature of this amount will be the same as that of a loan of that amount to the person who wants to encash the bill. The banks will draw the amount so loaned on completion of the terms of the bill from the entrepreneur or manufacturer or from his banker, and thus the responsibility of the person who wanted cash against the bill of exchange will terminate. If the bank does not receive the amount in question from the person who issues the bill on completion of its term, it will demand cash payment from the person who wanted to encash the same. Even in the conventional banking system the financial responsibility of the person who wanted to encash the bill continues until the person who in fact owes the money does pay the full amount of the bill.

What should be the maximum term for commercial bills of exchange? Which type of business should be given preference by the bank? etc, will be the subjects of the Central Banks' framing suitable regulations. If the Central Bank wants expansion in any specific area of business and wants to provide more facilities to

entrepreneurs in that area, it can accord preference to the bills of exchange in that area. We will clarify this issue in the chapter on the Central Bank.

The position of bills of exchange for import and export is somewhat different from those of bills inside the country. But, as our main objective here is to present a picture of financial affairs in a country that forbids interest, we will not touch on this issue. Briefly, it may suffice to indicate that if importing and exporting countries are both interest-free, there will be no new problem. There will, however, be a problem in the case of bills of exchange transacted between two countries of which one has the contemporary interest-charging system and the other has not. Here a new problem is created which can be solved in the light of policies we adopt in our financial relations with countries with conventional economies. This is a separate subject beyond the scope of our present discussion.

CHAPTER 5

The Process of Credit Creation

So far several prominent features of banking activity in an interest-free society have been discussed. A few persons invest their capital on the principles of partnership to set up the bank. The public deposit their savings and capital in the bank on the principles of *muḍāraba* and open current accounts (in the form of loan accounts) which also provide the bank with a considerable amount of capital for investment in addition to the *muḍāraba* capital. Ten per cent of the total holding in these accounts is allocated to the cash reserve. Fifty per cent of the loan accounts is reserved for advancing loans and the balance invested by the bank (along with the capital received on the principles of partnership and *muḍāraba*) or used to advance loans to business parties, to purchase commercial shares, and to pay for services which the bank needs. Profit earned from the use of capital in this way is paid to the people who deposit their money in the bank on the principles of *muḍāraba* proportionately. The balance of profit is distributed among the shareholders of the bank proportionately according to the capital invested by them. In exchange, the bank provides the public with the opportunity to protect their savings; the convenience of current accounts, and profitable use of capital and savings. The bank provides capital to the business community on the basis of profit-sharing and also advances short-term loans. Although the whole business is a profitable enterprise for the shareholders of the bank, it is also a great social service to the community.

The Nature of Bank Credit

An important function of the banking system is the supply of

credit or creation of new money: this is achieved through the banks' activities and may be further clarified as follows:

As far as control of the monetary system in an Islamic economy is concerned in modern times, there cannot be two opinions about its continuing in the hands of the State. The State alone must issue coins and currency and may establish a special institution for the purpose – no other individual or institution may share this prerogative. It is not here possible to discuss in full the monetary system of an Islamic economy. We would like, however, to express the view that this system will not be very different from the existing one: the modern Islamic State will issue rules and regulations regarding capital and money bearing in mind the economic condition of the country, operational convenience and other considerations in the light of present-day experience.

In an economy where banks are established, and currency is issued by the State, another type of money known as bank money will also be produced by the banking function. Bank money is founded upon the tendency of people to save and deposit a major portion of their income, savings and capital in the bank while withdrawing only small fractions of their deposits in cash; indeed, when an individual account holder has to transfer money to another person he does so often with a cheque and not with cash drawn from the bank. Cash withdrawals are made only to meet small expenses, large payments are made by cheque. A cheque is a document issued by an account holder to the bank with instructions to pay a fixed amount to another person. Normally this person does not demand the amount in question from the bank in cash, but deposits the cheque in his account, reducing by an appropriate amount the account of the payer and increasing the account of the payee. Most transfers of money are carried out in this way.

The bulk of the money drawn in cash by account holders who wish to make payments in cash comes back to the banks because the people they pay generally deposit the cash in their own current account (loan account) or savings account (*muḍāraba* account).

As people become used to withdrawing only fractions of their total deposits in cash, it becomes possible for the bank to utilise the major part of their deposits. We have proposed two alternatives in

our plan, namely to advance loans or supply capital to an entrepreneur on *muḍāraba* or on partnership basis. When the bank utilises the deposits of account holders in either of the above forms, new money comes into existence. This new money is the money paid to the borrowers or to the business which has acquired the capital on *muḍāraba*.

This practice has no adverse effects on the ownership rights of the account holders nor on their rights of appropriation because these rights have been conferred as a result of an agreement between the bank and the account holders.[1] However, the party to whom a loan is given or capital is supplied on *muḍāraba* can spend this capital for payment of salaries to employees, for payment of the cost of raw material, for payment of rent and so on. It is up to them to either pay these amounts in cash or deposit the capital in the bank's account intact and pay by cheque. Generally, depositing the money in the bank is preferred. The main reason for this is the general tendency to deposit income in the bank and keep only a small cash sum on hand for daily expenses. Those who prefer to spend immediately the money received from business parties will deposit it in a loan account and those more inclined to save will deposit in a *muḍāraba* account. It may be briefly noted here that a major part of the new business capital provided by banks to business parties on loan and on *muḍāraba* reaches the bank's account after passing through many hands.[2] The simple

[1]This is correct regarding both loan and *muḍāraba* accounts. In *muḍāraba* accounts the depositors of capital have themselves undertaken not to withdraw this capital for a definite period. As explained earlier, sometimes they will be able to withdraw their money even before the completion of the period.

[2]The existing system for advancing loans to the entrepreneur is that instead of paying the whole amount of loan to the borrower in cash, they transfer the cash to his account or if he is not an account holder then open an account for him and deposit his loan money in it. Sometimes the entries are made in such a manner that the borrower may draw the whole amount but he will keep a certain percentage of it in the account. The borrower will now withdraw the amount he needs from time to time by cheque payments. In view of this it is right to point out that the opening of this new account is itself tantamount to creation of new money. As a rule the same procedure may be adopted for payments of the amounts on *muḍāraba*. We have made this hypothesis only in order to explain the process by which the capital on loan or on *muḍāraba* ultimately reverts to the bank as a result of its being spent by the one who acquires it. In both cases the result is the same, namely, the capital advanced by the banks in practice remains with them.

reason for this is, once more, the general tendency to deposit income and savings in the bank, instead of keeping them on hand in cash, and using cheques to make payments.

When there is an increase in the loan and *muḍāraba* account of the bank due to the introduction of these new sums of money, it will become possible for the bank to loan and advance additional capital to business parties on loan and on *muḍāraba*. This is a long and ever-continuing process. However, as the banks consider it necessary to reserve a part of the total deposited with them in order to meet withdrawal demands, this process does come to an end at a certain point, and the capital provided to businessmen is always less than the capital coming into the banks. Consequently the process of creation of new money becomes shorter quantitatively and finally stops. But it stops after a very great increase in the total supply of money. The proportion between this increase in the total deposits in the very beginning depends on the discretion of the bank in keeping the cash reserve according to the volume of their deposits. It is of supreme importance for the formation of bank money that the bank does not preserve its whole capital in cash, and that it does advance a major part of it to the business parties on loan and on *muḍāraba*. For the major part of capital procured through the banks comes back into the bank's accounts – in consequence of which it becomes possible for the bank to provide further capital on loan or *muḍāraba*.

Out of any country's money a certain portion (in coins and currency) circulates among the people and a second part is preserved in the bank's treasuries as cash reserve. The people keep on hand only such cash as will meet their small daily expenses. The banks keep some money in cash for emergency or for business needs so that they should have no difficulty at any time in meeting normal withdrawal demands from their account holders nor even in the event of a sudden change in the normal requirements. Although the bulk of the income or savings and capital of the public is deposited with the banks, not all of it is kept in cash, but is entered in bank ledgers. As the bank can rely upon its cash reserve to arrange prompt payments as required by

account holders,[1] the entries in the ledgers serve as money. This means that only a small part of the total money supply is in the form of coins and currency while the larger part remains in the form of accounts or entries in the banks' ledgers.

The volume of deposits or bank credit, therefore, depends upon the amount of cash in the banks' custody. As the level of the cash reserve changes, so the volume of deposits expands and contracts. Another way in which additional capital might come into the bank would be if the public decided to deposit some part of the circulating cash or of cash accumulated by the public – if, in other words, there should be a decline in the public demand for cash. When the bank gets a new cash in-flow, it may be possible to take steps which will result in the production of bank-money several times greater than the new cash. Conversely, with increased public demand for cash, there is a decrease in the bank's cash reserve and it may be forced to take steps which will result in a manifold decrease in bank-money. There is another cause of shortage or surplus supply of cash to the bank which will be described in the next chapter. Study of the function of the Central Bank will show that an expansion or reduction in bank money or credit (due to increase or decrease in the public demand for cash) will largely depend upon the policy of the Central Bank. If the Central Bank so desires it may take steps to prevent these changes, and supply of money may stabilise. In the modern economy efforts are being made to keep the total supply of money under the control of the Central Bank instead of leaving it at the mercy of the caprice or mood of the public. As we have not yet studied the position of the Central Bank in the banking system as a whole, it is best to defer discussion of it at this stage. We will, therefore, comment on the process of money creation assuming the fluctuations that depend upon in- or out-movements of cash, according to what the public chooses to do.

Nowadays, the banks, besides keeping a fixed percentage of currency deposited in their accounts in cash reserve, spend a certain percentage of it in giving call loans and in purchasing such

[1]While operating within the framework of rules and regulations mentioned above regarding withdrawal from the *muḍāraba* account.

securities as may be promptly resold if need be.

Alongside the cash reserve, a secondary reserve is created which may be converted into cash without delay. Against these assets, loans repayable on demand, and high class certificates, the banks also earn some interest at the ordinary rates, and rely on these to be able to meet withdrawal demands. In the previous chapter we discussed only the cash reserve, but in the next we shall also explain the assets which may be used as secondary reserve in an interest-free economy.[1] As the nature of these assets have not yet been defined, we will discuss the issue assuming at this stage that the cash reserve of the bank is adequate to meet withdrawal demands.

The Process of Money-Creation

In order to clarify the process of formation of bank money in an interest-free banking system, it will be useful to give some numerical examples: These examples are based upon the following five presuppositions:

(1) The banks keep 10% of the total deposits of their *muḍāraba* and loan account as cash reserve to meet withdrawal demands for cash, and this 10% is always sufficient.

(2) The capital withdrawn from the bank on loan or on *muḍāraba* is normally deposited back in the bank loan or *muḍāraba* accounts.

The justification for these presuppositions was given above. But the fact remains that the capital got from the bank does not come back in its entirety – a small part of it circulates among the people in the form of cash. The presupposition that all the capital comes back is intended simply to avoid complications in the numerical examples. If we supposed, for instance, that one fifth of the total capital remains in circulation while 80% comes back into the bank's accounts, the numerical examples could be given, but their calculation would be complex. As the result of the discussion is the same in either case, we will then proceed assuming that all the capital comes back into the bank's accounts. Subsequently, we

[1]See *Central Bank*, Ch. 6, and *Banking System and Public Finance*, Ch. 7.

will drop the presupposition, simply to confirm that doing so does not affect the result of the discussion.

(3) The proportion that is found between the loan and *muḍāraba* accounts at the outset remains constant even in the event of increase or decrease in the total volume of the deposits. We supposed earlier that 60% of total deposits were made in the loan account and 40% in the *muḍāraba* account.[1] Now we shall further suppose that whenever new capital is deposited, 60% of it goes to the loan account and 40% to the *muḍāraba* account. When the bank has provided capital to business parties with a consequent increase (from profits, etc.) in their account, this increase too, we shall suppose, will be divided between the loan and *muḍāraba* accounts in the same proportion. Likewise withdrawals from the bank will be made in the same proportion. The justification for the 60-40 ratio between the two accounts is that it reflects public habits and attitudes and, unless these change, there is no reason why that ratio should change with any expansion or reduction in the volume of bank deposits. Even if there is such a change it will be temporary; the ratio will shortly re-establish itself, based as it is on the needs of the public to save and to spend, and the balance between the desire for profit and the desire for security.

This 60-40 proportion avoids complexity in our numerical examples. Of course, we might have worked on the basis of some different proportion between the accounts and still calculated precisely the process of credit supply, but the numerical complication that would eventually result would in no way clarify the general principle involved.

(4) As we did earlier we shall suppose that the bank utilises 50% of the deposits in its loan account for advancing loans and, after the cash reserve, utilises the balance for investment on the principles of *muḍāraba* for purchasing shares, and organising

[1]As explained above the capital procured by the partners who have established the bank is also included in the *muḍāraba* account in order to avoid complications in the bank's statements, the numerical examples. One of the implications of entering this capital in the column of liabilities is that cost of bank buildings, furniture and other durable things may be entered in the column of assets. But for the sake of convenience this has not been presented separately. For the present discussion it is not necessary to mention the capital provided by the partners and the fixed assets of the banks.

other necessary services. For the sake of convenience, however, only provision of capital on *muḍāraba* has been mentioned in the numerical examples. Purchase of shares, provision of services and other profitable work may be considered as included in this programme.

(5) There are various banks in the country. The capital supplied on loan or *muḍāraba* by one bank does not come back into the account of the same bank, but different bits of it come back into many banks. It therefore follows that every bank will get back part of the capital it supplied and part of what other banks have supplied.

Hence our second proposition that all the capital procured from the bank on loan and on *muḍāraba* is in the end deposited in the bank account, may be accountable if all banks are considered together as one system. It would be difficult to apply it to any individual bank. We can overcome this difficulty by assuming that there is only one bank in the country for transactions for all individuals and organisations; though in reality there are numerous banks in any country. This view of all the banks together should also be applied when considering the examples below.

Examples

First of all we prepare the statement of accounts of all banks in the country on a scheduled date. In the column on the right side of this statement are entered the sums deposited in the loan and *muḍāraba* accounts. From the bank's standpoint these constitute its liabilities because the bank is responsible for their repayment. In the column on the left side is explained how the bank has utilised this capital. The cash reserve, the loan advanced and the capital provided on *muḍāraba* constitute the assets of the bank. The total assets and liabilities should balance.[1]

[1] It is not the responsibility of the bank to refund all the amounts deposited in the *muḍāraba* account – similarly it is also possible that the whole capital procured by the bank on the basis of *muḍāraba* will not revert to the banks and may be reduced. If as a result of a loss there is a reduction in the assets of the bank the same decrease will ultimately take place also in its liabilities, thus maintaining a balance between assets and liabilities. As explained above if there is a loss as a result of advancing the amounts on *muḍāraba*, from *muḍāraba* account,

Continued on next page.

In the statement below, that part of the receipts of capital has not been shown which is circulating in cash in public hands in the form of currency notes and coins. For the purposes of these examples it will be assumed in this discussion that the total supply of money and the total of the bank accounts are one and the same figure; the money in public hands in the form of cash will be ignored. It does not affect our conclusion if some part of the total supply of money is found in the form of cash in public hands. When, however, there is a fluctuation in demand for cash (i.e. when the public wants a bigger or smaller amount of cash) there will be some effect on the total supply of money – a problem that will be explained in subsequent paragraphs:

**PRELIMINARY STATEMENT
OF THE BANK'S ACCOUNTS**

ASSETS			LIABILITIES	
Muḍāraba	Loan	Cash Reserve	*Muḍāraba* Account	Loan Account
60%	30%	10%	40%	60%
Rs.60,000	Rs.30,000	Rs.10,000	Rs.40,000	Rs.60,000

This statement shows that Rs.100,000 are deposited with the bank in the beginning of the period under review. Rs.60,000 are deposited in the loan account, and Rs.40,000 in *muḍāraba* account. The bank has kept Rs.10,000 in cash reserve and has advanced Rs.30,000 as loans. The balance of Rs.60,000 has been provided to business parties on the principles of *muḍāraba*. There is a balance in the bank's accounts. Now if more cash is deposited this balance will be disturbed and there will be a change in the above statement. Supposing that the public deposited the sum of

Footnote 1 continued.

the loss will be sustained by all the account holders. If a portion of loan accounts has been advanced by the banks on *muḍāraba*, the responsibility for loss will weigh on the shoulders of the bank's shareholders. Conversely, if the bank has earned a profit by advancing capital on *muḍāraba* this profit will be included in the liabilities after being included in the dividends of the shareholders.

Rs.1,000 in cash, i.e. Rs.600 in loan account and Rs.400 in *muḍāraba* account. Now the bank, against this new responsibility of Rs.1,000, can make provision by adding Rs.100 to its cash reserve to meet any demands from new account holders as and when needed.

The bank may wish to utilise the cash balance of Rs.900. It has to allocate Rs.300 to loans because there has been an increase of Rs.600 in its loan account. The bank will want to make the balance of Rs.600 available to entrepreneurs on *muḍāraba* in order to earn profit. Supposing that there is a demand and the bank makes the Rs.600 available on *muḍāraba*, the resulting change in its statement will be as shown below. The first line shows the effects of new deposits of Rs.1,000 on the assets side of the statement: it will be seen that all the new capital was immediately added to the cash reserve. The second line shows the position when the bank has used its surplus cash. In the second line, however, the column of liabilities has been left blank for the reason that the amount entered in the first line would not be entered therein.

FIRST PHASE
ARRIVAL OF NEW CASH IN THE BANK

ASSETS			LIABILITIES	
Muḍāraba	Loan	Cash Reserve	*Muḍāraba* Account	Loan Account
Rs.60,000	Rs.30,000	Rs.11,000	Rs.40,400	Rs.60,600
Rs.60,600	Rs.30,300	Rs.10,100		

As explained above the sum of Rs.900 received by entrepreneurs from the bank on loan or on the principles of *muḍāraba* will ultimately be deposited back again in the bank. Now 60% or Rs.540 will be entered on the loan account and 40% or Rs.360 in the *muḍāraba* account. This means an addition of Rs.900 in the bank's cash reserve. But against the new responsibility of Rs.900, the bank would consider an increase of Rs.90 only in its cash reserve, and will utilise Rs.810. As there has been an increase of

Rs.540 only in the loan account, therefore, assuming that there is a demand from the public for loan, Rs.270 will be made available and the balance of Rs.540 may be provided on the principles of *muḍāraba* to those in need of (investment) capital. These steps have been described as follows:

SECOND PHASE
INCREASE IN THE SUPPLY OF MONEY

ASSETS			LIABILITIES	
Cash Reserve	Loan	*Muḍāraba*	Loan Account	*Muḍāraba* Account
Rs.11,000	Rs.30,300	Rs.60,600	Rs.61,140	Rs.40,760
Rs.10,190	Rs.30,570	Rs.61,140		

As usual the first line shows what happens as the new capital comes in, the second what happens as it is used. But this too is a temporary phase as the process explained above will continue and thus additions to the figure of the bank's total deposits will also continue. In other words the process of creation of new money would continue. In the end a stage will come when the total increase in the volume of bank deposits will be Rs.10,000 against which the bank will have made an addition of Rs.1,000 in its cash reserve. The whole amount of capital received by the bank at the beginning of this process will be included in its cash reserve and now the process of expansion in the supply of money will be stopped. In the consolidated statement the bank account will be as follows:

LAST PHASE
BALANCE OF INCREASE IN THE SUPPLY OF MONEY

ASSETS			LIABILITIES	
Cash Reserve Rs.11,000 (Rs.1,000)	Loan Rs.33,000 (Rs.3,000)	*Muḍāraba* Rs.66,000 (Rs.6,000) (increase)	Loan Account Rs.66,000 (Rs.6,000)	*Muḍāraba* Account Rs.44,000 (Rs.4,000)

It has been indicated within brackets in the second line how much addition has been made in the supply of capital in the various accounts and assets as compared with the beginning. Now the statement of account is balanced and there is no surplus that may be utilised for generation of additional credit. From the many stages through which the banking activity has passed in the conversion of the previous statement into this statement, two have been described in the above tables. However, the following is a result of increases in the supply of money, presented phase by phase:

PHASEWISE STATEMENT OF INCREASE IN SUPPLY OF MONEY

PHASES	Increase in Bank Accounts	Increase in the Cash Reserve	Increase in the Capital on Loan and *Muḍāraba*
Arrival of new capital			
1st phase	Rs.1,000	Rs.100	Rs.900
2nd phase	Rs. 900	Rs. 90	Rs.810
3rd phase	Rs. 810	Rs. 81	Rs.729
4th phase	Rs. 720	Rs. 73	Rs.656
5th phase	Rs. 656	Rs. 66	Rs.590
6th phase	Rs. 590	Rs. 59	Rs.531
7th phase	Rs. 531	Rs. 53	Rs.478
8th phase	Rs. 478	Rs. 48	Rs.430
9th phase	Rs. 430	Rs. 43	Rs.387
10th phase	Rs. 387	Rs. 39	Rs.347
Etc.			
Etc.			
Total of all phases	Rs.10,000	Rs.1,000	Rs.9,000

Every line of the above statement shows that out of any increase in the total volume of its deposits, the bank includes only one tenth in its cash reserve and utilises the remaining nine-tenths in its business.

The same banking capital, as a result of its utilisation by the bank in phase one, appears in the form of increase in the bank's account in the second phase, and thus the process of increase in the capital provided in *muḍāraba* account, cash reserve and loan account continues. Study of the various columns of the account shows that every new increase is smaller than the previous one. The amount of increase also decreases. In the first phase there was

an increase of Rs.1000 but it is only Rs.387 in the tenth phase. A stage may be envisaged when the amount of increase is near to zero. The total amount of increase after ten phases is Rs.6,500, but on completion of all phases this total becomes Rs.10,000.[1]

The column of cash deserves special condieration. The typical bank practice is to reserve 10% of the amount of its liabilities as cash reserve against an increase in the account. Therefore every entry in this column will be one tenth less than the preceding one. As the figures in this column are 9/10 of every phase as compared with various phases therefore the increase in the cash reserve goes on decreasing until the stage is reached when it becomes nil. In this column the total is Rs.652 and that of all the phases is Rs.1,000. The last column shows the rate of increase in the capital provided by the bank on loan and on *mudāraba* due to arrival of new capital. The amount of increase in every phase is less than the preceding one and a time will come when this figure comes near to zero and by that time the total of increase is Rs.9,000. This is the same phase in which the possible increase in the cash reserve and bank account becomes zero. At this stage expansion in the supply of money stops, because it depends upon the arrival of new capital in the account. In other words, in the last column when the bank has utilised its surplus cash and when it has no surplus, no further utilisation is possible.

The study of the column totals on completion of all phases shows that the capital of Rs.1,000 received by the bank has been wholly included in the cash reserve and, due to this, the supply of money has been increased by Rs.9,000 which is deposited in the loan and *mudāraba* account in the name of various account holders who can exercise their right of ownership by making withdrawal demands. This Rs.9,000 is bank-money which has come into existence purely as a result of banking business, initiated by receipt of new cash at a time when the business community had a demand for capital.

The total supply of capital was Rs.100,000 prior to the activity

[1]According to an established formula the total of an infinite series is as follows:

$$1 + \frac{9}{10} + \left(\frac{9}{10}\right)^2 + \left(\frac{9}{10}\right)^3 + \dots\dots\dots\dots = 10$$

under review but now it is Rs.110,000. Out of this total, Rs.1,000 is the amount actually deposited and Rs.9,000 is generated by banking business. This new money is in the form of bank accounts. Bank accounts are money in that every account holder can make withdrawals which must be paid by the bank in cash, or he can order the money transferred to other accounts which also must be honoured by the bank.[1] Every new account is new money and an increase of Rs. 10,000 in the bank accounts is thus an increase of Rs.10,000 in the supply of money.

We have shown how the process of production of bank-money and expansion of credit is accomplished when the bank receives new cash. As the fundamental principle of banking is to earn profit, the bank will use the balance of cash (after putting aside a percentage in cash reserve) to make new capital available to the entrepreneur. As a result of this new capital investment the same process of money generation will operate as we have described above.

It is important to emphasise that there is no effect on our conclusions if we change assumptions made above for the sake of arithmetic simplicity in our examples. Our initial proposition was that there is a ratio of one and ten between the cash reserve and bank account. If we suppose that the ratio is one and five or one and twenty, this affects only the particular figures in the various columns of our above statement, not the principle involved in their computation. If the cash reserve is only 5%, there will be an increase of Rs.20,000 from new cash deposits of Rs.1,000 and if the cash reserve is 20% there will be an increase of Rs.5,000 in the supply of money. The process is not affected, new money will come into existence and the supply of money will increase.

It is similarly important to emphasise that, if a separate ratio of

[1]No instant withdrawal will be allowed from *mudāraba* accounts, advance notice being required for such withdrawals. In view of this only loan accounts may be regarded as money. In such case the nature of the process of expansion in the supply of money explained in the above examples will not be influenced. We may, however, say that the total supply of money has been expanded to the extent of Rs.66,000 from Rs.60,000. The alternative situation is that banks will organise their business in such a manner that *mudāraba* account holders may be paid without delay, in which case the difference between loans and *mudāraba* accounts may be ignored. We have followed the same procedure for the explanation, although it would be much better from the theoretical standpoint that only loan accounts are considered as money.

cash reserve for loan or *muḍāraba* account is fixed this too will not affect our conclusions. Supposing that 10% of cash is reserved against loan and 5% against *muḍāraba* account, the cash reserve of the bank will initially be only Rs.8,000 and the capital on *muḍāraba* will be Rs.62,000. The arrival of new capital of Rs.1,000 will result in an increase of Rs.12,500 in the supply of money and except for this change in amount there will be no effect on the principles of money supply and of the generation of new money.

The other assumption was that the capital provided on loan and on *muḍāraba* comes back in its entirety to the bank's accounts. Now if this assumption is set aside and it is supposed instead that 1/9 of the capital made available remains in public hands and only 8/9 is deposited in the bank account, every increase in the total volume of bank deposits in the above phasewise statement of increases will be only 4/5 of the preceding increase, and the total increase in the supply of capital will be only Rs.5,000. Moreover there will be an increase of only Rs.500 in the bank's cash and out of the new capital of Rs.1,000 previously deposited in the bank Rs.500 will remain in circulation. Details are shown in the statement below, which explains the state of the accounts after some phases, given the new assumptions:

Increase in Cash in public hands	Increase in the Capital given on Loan and *Muḍāraba*	Increase in Cash Reserve	Increase in the Bank Account	Phases
	Rs.900	Rs.100	Rs.1,000	1st phase arrival of new capital
Rs.100	Rs.720	Rs. 80	Rs. 800	2nd phase
Rs. 61	Rs.570	Rs. 51	Rs. 640	3rd phase
Rs. 48	Rs.461	Rs. 41	Rs. 512	4th phase
	Rs.369		Rs. 410	5th phase
Rs.500	Rs.4,000	Rs.500	Rs.5,000	Total of all phases

It can be seen from the above statement that the process of money generation is not based upon the assumption that no part of the capital provided by the bank should remain with the public, that all of it should be deposited back in the bank account. It is enough if some part of the capital added comes back to the bank account. In view of common practices, it is realistic to suppose that the largest part of the capital provided by the bank comes back into the bank account in the end. The holding back of a part of it simultaneously affects the ratio of total increase in the supply of money and the initial arrival of new capital. The process of expansion in the supply of money, however, continues on the arrival of new capital. Our third and fourth propositions have no direct relationship with the process under review because it depends upon the change in the total volume of the bank deposits and not on the proportion between the loan and *muḍāraba* account. If the ratios of reserve against both the accounts vary, and if the proportion between these accounts is changed in the middle phases, the figures in the above statement will be changed considerably. But even after this change the process of increase in the supply of money will continue and will do so as explained above. Obviously if one-third instead of half of the loan account is loaned it will result in an increase in supply of capital procured on the principles of *muḍāraba* and the expansion in the supply of money and the process of production of bank money will remain unaffected.

It can be concluded from the above discussion that the production of bank-money under an interest-free system will be governed by the same causes and factors as in the conventional banking system.

Mostly, people deposit their money in the bank and withdraw a small fraction of it in cash (because most of the transfers are made through cheques). It is a tradition of banks that they utilise all the capital deposited with them except for a small proportion held against public demand for cash. The process of banking and production of bank-money is not affected if the bank provides capital on interest or on terms of participation in profit or on the basis of paying out to account holders a part of profit earned on the capital deposited by them. This is an important conclusion.

Although it can be easily understood as it is based upon a simple fact, yet it is essential for those to clearly grasp it who feel that, if interest is prohibited, banking cannot possibly survive, that the expansion of credit will stop and the whole economic system fall victim to extraordinary restrictions and strangulations.

Cancellation of Bank Credit and Reduction in the Supply of Money

Just as bank business expands on the arrival of new cash which in turn generates new money, so, also, if account holders withdraw money from their accounts and if (because of an increase in demand for cash) the money withdrawn does not return to the bank accounts, bank business contracts and results in extinction of a part of the money supply. In the following paragraphs we shall explain briefly how the process of decrease in the total money supply and the cancellation of bank credit comes about due to reduction in the bank's cash reserve.

As usual the ratio of one to ten will be supposed for the cash reserve and the total volume of bank accounts. Our second supposition is that whenever the bank gets back the capital advanced to entrepreneurs on loan or *muḍāraba*, this signals a proportionate withdrawal of capital from its accounts. This is so because, when the entrepreneur closes down a business or contracts it he reduces some people's income. The people (labourers, shopkeepers, employees, owners of houses and shops, etc.) whose income is reduced or annulled will have to withdraw from deposits to meet their deficits. Ultimately, the general reduction will reach the entrepreneur's accounts also. The assumption that the decrease in the bank's accounts will be equivalent to the capital withdrawn is made to avoid complexity in the numerical examples. It is of course perfectly likely that the decrease in the volume of bank deposits will be less than the withdrawn capital but our supposition has no effect on the principle of reduction in the money-supply.

As explained above, we also suppose that the initial normal ratio between loan and *muḍāraba* accounts continues even through the decrease in the total volume of bank deposits.

Obviously, when the bank withdraws capital from the entrepreneurs and factories close or their size is reduced, the income of many people will be reduced also and they will be forced to spend their savings. Even the bank accounts of the entrepreneurs will be affected by the return of the capital. We are supposing for convenience sake that the overall reduction in the total volume of accounts will be represented in the loan accounts at 60% and in the *muḍāraba* account at 40%. The proportion can be ignored hereafter because it has no effect upon the relationship of both accounts with the cash reserve.

Suppose that a sum of Rs.1,000 is withdrawn from the bank's loan and *muḍāraba* accounts. The bank pays out this sum in cash and because of increased public demand for cash, this cash does not return to the bank. Now the bank's cash reserve is reduced by Rs.1,000 and eventually the volume of bank deposits is also reduced by Rs.1,000. The bank will want to reduce its cash reserve by only Rs.100 (against an actual reduction of Rs.1,000 in its total deposits). But the unintended (real) decrease of Rs.900 will oblige the bank to seek ways of getting new cash. In effect, the bank will be obliged to call in capital, used in advancing loans or on *muḍāraba*, (or by sale of shares). As there has been a decrease in loan account amounting to Rs.600, it can recall loans amounting to Rs.300 only. The balance of Rs.600 will come from capital advanced on *muḍāraba* (or by sale of shares). Whatever methods are adopted to call in capital, ultimately it is withdrawn from the entrepreneurs.

When they pay back a sum of Rs.900 to the bank, an additional sum of Rs.900 is withdrawn from the bank's accounts, as a result of which there will be an unintended (real) reduction of Rs.810 in the bank's cash reserve. In order to meet this deficit it will call in a further sum (Rs.810) from the entrepreneurs. The process of capital withdrawals from the bank and from the bank's accounts will continue. In every phase there will be a decrease of 9/10 of the preceding phase in the total bank deposits at every stage. The decrease in the size of the bank deposits will diminish gradually and finally terminate at the point where there will have been a total decrease of Rs.10,000 in the bank deposit. Its existing cash reserve, reduced to Rs.9,000 after paying out Rs.1,000 will be

adequate against the existing total volume of bank deposits. Thus there will again be an equilibrium in the bank account. A condensed statement of it for both the periods under review follows:

ASSETS			LIABILITIES	
Cash Reserve	Loan	*Muḍāraba*	Loan Account	*Muḍāraba* Account
Rs.10,000 Rs. 9,000	Rs.30,000 Rs.27,000	Rs.60,000 Rs.54,000	Rs.60,000 Rs.54,000	Rs.40,000 Rs.36,000

The details of the intermediate phases are not shown as phase-by-phase diminution figures can be easily worked out on the same basis as above for capital expansion. In principle this process matures and terminates in the same way as the process of phase-by-phase increase in the volume of bank deposits. In brief, it means that finding their cash reserves smaller than they should be, banks recall some of the loans and *muḍāraba* advances. This returning of capital decreases the total in the bank deposits; the bank in consequence does not receive any new cash. But the decrease in its accounts is such that its cash assets become one tenth of the new total volume of deposits. In the above example, the decrease of Rs.10,000 in the bank deposits includes Rs.1,000 transferred to public hands from the bank's treasury in the form of cash. The further reduction of Rs.9,000 has occurred as a result of extinction of bank deposits. These deposits have become non-existent because the bank has withdrawn capital amounting to Rs.9,000 from the entrepreneurs as compared with the previous transaction. Thus the extinction of deposits is tantamount to extinction of bank money. Now the increase made by bank's customers in their cash reserve should exist somewhere in the form of currency notes, but this amount of Rs.9,000 does not in fact exist. A part of bank money produced by past expansion in the banking business has evaporated as a result of decrease in the business.

If, when the bank calls back capital advanced on loan or *muḍāraba*, the consequent withdrawals from the bank's accounts are less than the capital it has called back, the amount and rate of phase-by-phase decrease will be smaller than that shown in the above examples, and the overall decrease will also be proportionately smaller. For example, if the amounts withdrawn are 8/9 of the capital returned to the bank the overall decrease in the supply of capital will be Rs.5,000. The details can easily be worked out on the same basis as above for credit expansion. It therefore follows that the process of reduction in the supply of credit is not based on the principle that the reduction in the bank deposits should correspond to the capital called back.

Similarly, a change in our other proposition does not affect the result that reduction in the cash reserve causes extinction or reduction in the banking credit. Different ratios between cash reserve and the total volume of bank deposits or between loan account and *muḍāraba* account or loan account and advances do not alter our conclusion.

We have established that capital is generated or diminishes as a result of increase or decrease in banking business. We have also shown that as these expansions or reductions in the banking business largely depend upon increase or decrease in the public demand for cash and on the policy of the Central Bank, the creation or cancellation of credit is not wholly in the bank's power. The real limits of the bank's power to expand credit facilities is beyond the scope of this preliminary study. It must be pointed out, however, that banks can plan an active role in the extinction of credit and production of bank money even within the limits imposed by the Central Bank. This role is strengthened where the banks, as is generally the case, keep larger cash reserves than normally or theoretically necessary: the existence of secondary reserve, convertible to cash as needs arise, steady the banks against fluctuation in banking business. They will not be forced so readily to call back capital advanced to entrepreneurs, thereby initiating a process of reduction in banking capital. To this end, banks may not wish to direct all new deposits into the general banking capital but may utilise it, instead, to strengthen their cash reserve.

Profit or Loss in the Banking Business and the Process of Money Creation

The process of expansion of credit due to receipt of new cash at the bank or contraction of credit due to withdrawals by the public explained above is not affected by the assumption that the banks are earning profit. In the proposed banking system profit would be earned on capital only when the commercial or industrial sector is making profits. Eventually, because of profit there will be a demand from that sector for more capital. As the banks receive new cash their business will expand and the supply of capital will increase.

As there is an increase in demand for capital due to increase in the productivity of capital in the economy the Central Bank should provide for an increase in the supply of money so that there is an increase in the supply of money corresponding to the supply of goods. If this is not done the prices of goods and services will fall. If reduction in prices continues for a long time, the profits of the business group end or decrease, and this leads ultimately to the discouragement of entrepreneurial activities and to a drop in the level of employment, income and production.

If the banks earn profit but because of some steps taken by the Central Bank, there is an increase in public demand for cash and hence a decrease in the bank's cash reserve, the banks will not be able to expand their business whatever the demand for capital. On the contrary, they will be forced to call back capital from the entrepreneurs and a decrease in the supply of money will inevitably result. If banks are forced to take such action and should the run of decrease in the supply of money continue over a long period business activity will shrink with consequent unemployment, reduction in income, decrease in effective demand; of course, the business group would lose, which would in turn cause a loss in the banking business. For profitability in the banking business it is essential that there be an increase in the supply of money along with increase in productivity and a correspondingly speedy expansion in business, but this is very much in the hands of the Central Bank. It is unthinkable that the Central Bank of any country would adopt such a policy as would result in the situation

described. Further elaboration of this lies beyond the scope of this study. We intend only to establish that an increase in cash reserve results in an expansion of money supply and a decrease in cash reserve in a reduction of money supply. The fact that banks can earn profit is not relevant to that proposition. The circumstance cannot be envisaged where all banks together suffer a loss in their business because this can occur only when the capital investment of all the entrepreneurs fails to achieve any positive result. The natural consequence of capital investment is increase in production, not decrease. It is possible that a few entrepreneurs may suffer a loss due to wrong business decisions, but a loss to all the entrepreneurs is possible only where the prices of commodities register a sharp fall due to recession. The responsibility for such a state of affairs would lie on wrong policies in public finance and monetary control, which are not the theme of this chapter. The Central Bank may introduce reforms by taking suitable steps for the expansion of bank credit and the Government can immediately deal with the situation by adopting the policy of expansion in public finance. Now, in the circumstances that all banks are suffering a loss we would like to note the effects of arrival of new cash in banks or decrease in their cash reserve.

When business suffers a loss in its enterprise, the demand for capital naturally declines. If in this situation the banks receive new cash, they cannot expand their business since, in the absence of demand for additional capital, they cannot use new cash to set in motion the process of expansion in money supply. In the event of a decrease in the cash reserve larger than can be accounted for by the smaller volume of deposits, a steeper reduction in money supply will result, and at a faster rate. This may, however, occur only as a result of a wrong policy of the Central Bank.

In the case of a loss, the failure of an increase in cash reserves to increase the supply of money is not contrary to the conclusions of our discussion. As we have already explained above this process depends upon a demand for capital on the part of entrepreneurs. Decrease in demand for capital due to loss in business deprives the new cash of its potentiality for expansion.

CHAPTER 6

The Central Bank

Role and Functions

In order to manage the country's economic system, to supervise and guide the banks, and to implement the monetary and commercial policies of the State there will be a Central Bank under state control, whose aim will not be to earn profit but to safeguard the public interest and to promote public good.

The Central Bank will function in interest-free banking just as it does in the interest-charging system. It will issue currency notes[1] and be the government bank, in which the government will open its accounts[2] and execute transactions with foreign countries. The Central Bank will also be responsible for the supervision of financial and monetary affairs with foreign countries,[3] and for all

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[1]This is not an essential function of the Central Bank – the government may even discharge it directly – but in all modern economies, for the sake of convenience it has been assigned to the Central Bank. The powers of the Central Bank regarding the issue of currency notes will be governed by the rules and regulations framed by the central legislature. We have not discussed this function in the following pages on the role of the Central Bank nor discussed what rules should govern its exercise. This was not relevant to the study of the relationship between the Central Bank and commercial banks. It will, moreover, become necessary to deal with matters pertaining to capital finance and the economy for the above discussion.

[2]It is not necessary that the government be an account holder of the Central Bank alone. It may deposit its capital even in the commercial banks, as is done in the United States of America. But the proposition that the government should deposit all its capital in the Central Bank and even draw loans as needed will very greatly influence the roles and functions of the Central Bank, specially the issue of currency notes. We have proposed that the government be the account holder of the Central Bank, as is done in Great Britain, but we have avoided a discussion on the difference between the above two methods. This difference has no positive reference to the inter-relationship of Central Bank and commercial banks and it is to that relation that our attention is directed.

[3]This function of the Central Bank is not elucidated here. It may be assumed, for our present purposes, that the country is self-sufficient and has no financial relations with any other country. In this preliminary study of the banking system this assumption will create great convenience. Foreign trade and its functioning along with an interest-free banking system could be studied separately.

monetary matters resulting from any transactions with foreign countries. The Central Bank will function as a bank for other banks just as ordinary banks do for individuals and entrepreneurs. All the banks will open their accounts with this bank and draw loans from it as needed.

The Central Bank will watch the general trend of business, employment, incomes and prices and take necessary steps to promote their general standard and maintain them at a desired level. It will direct capital investment to those areas of industrial and economic development where such investments need to be kept up, bearing in mind above all the general interests of the public. It will seek to balance the availability of capital and credit facilities with the demand for them. Bearing in mind the public demand for cash and the need for cash in ordinary banks, the Central Bank will make necessary adjustments in the supply of cash. It will provide all the banks with cash as needed, and organise their activities according to the needs of the people. The Central Bank will discharge such functions to meet the financial needs of the State as are defined among its duties and responsibilities. These will include, for example, provision of temporary loans to the State; advancement of capital on the State's behalf to members of the public or businesses and banks – on the basis of loan, partnership or on *muḍāraba* – by providing necessary capital and guarding the stability of state-issued shares against inflation or deflation in the market.[1] The Central Bank will keep watch on the value of the national currency both at home and abroad and protect it from any changes that may be detrimental to the country's interest.

The advice and guidance of the Central Bank will be the major factor in encouraging commercial banks to formulate their policies in the larger public interest in accordance with its declared principles. The Central Bank will be responsible for the dissemination of necessary information, including up-to-date statistics on the current state of banking business. The information will be addressed to banks and business institutions and aim to

[1]The question of government finance and the shares issued thereby has been dealt with separately, in the next chapter.

keep them abreast of practical methods and techniques for the supply of capital and various avenues for capital investment. It will give details regarding areas of trade and industry where capital investment on loan or *muḍāraba* would be most beneficial, so that capital investment may be given priority in those areas. Similarly it may advise banks if some particular additional capital investment is beneficial or detrimental to the common interest, so that they are discouraged from wasting common resources.[1]

Although it is generally anticipated that, in most cases, information about desired policy (formulated through mutual consultation) will be sufficiently persuasive for commercial banks, the Central Bank may also oblige banks to comply, in their own common interest. If found unavoidable these instructions may be given the force of rules and regulations. Under normal conditions the aim will be to arrive at common ground through consensus amongst policy-makers of the Central Bank and the commercial banks. The decision of the Central Bank will, however, be considered final and binding in disputed cases. The powers and jurisdiction of the Central Bank over the commercial banks may be decided by the legislature, which will define under what circumstances and in what manner the Central Bank may issue directives. This decision is generally to be founded upon certain principles, yet every effort should be made, in spite of the overall control by the Central Bank, to ensure that the commercial banks enjoy all the facilities to freely and fully conduct their own business and earn profit. A congenial atmosphere should be sought to promote mutual co-operation and confidence between the Central and the commercial banks.

Fundamental Byelaws

Although it is not possible to present here all the details of the above issues, we shall, in the discussion following, explain in greater detail some of the central and critical issues regarding the inter-relationship of Central Bank and the commercial banks; and indicate how the Central Bank's control over money and banking

[1]A detailed discussion on this important function of the Central Bank is also beyond the compass of our present discussion.

is exercised in practice. Such rules as are necessary should be set down and clearly understood from the very beginning in order to achieve the general objectives, in particular expansion or reduction in the money supply, but the Central Bank must have power to issue amendments as necessary. These rules will guarantee the confidence and trust of the general public in the Central Bank and ensure that, with proper guidance, supervision and patronage by the Central Bank, the commercial banks are helped to honour the agreements they have made with the general public. These rules are as follows:

1 It will be obligatory for all the banks to reserve a fixed part of their capital, deposited in their loan and *muḍāraba* accounts, in the form of cash. We will hereafter call the proportion between cash reserve and the total number of bank accounts, the 'reserve ratio'. We propose that this ratio be 10%. Small banks or branches that are located where there is no branch of the Central Bank may, however, be exempted from compliance with this rule for their operational convenience. They may be obliged to keep the share of cash reserve of the Central Bank in its account with themselves. This method is also in practice in the existing banking system. A portion of this cash reserve should normally be deposited with the Central Bank.

It is not intended by this rule that the cash reserve of every bank must always be maintained at 10%: it may suffice that every week the daily average of the cash reserve is 10% of the daily average of the total volume of bank deposits. Similarly it will also suffice that the amount deposited by the bank in its account in the Central Bank be half of the above average cash reserve every week.

As we noted above, every bank will open an account in the Central Bank. Half of the amount of cash reserve of all the banks will be deposited in this account. The banks will be free at the same time to keep surplus cash in their accounts, in addition to the compulsory reserve. The banks may withdraw this surplus cash at any time or transfer it to any other bank or institution. They may utilise their compulsory reserve only on condition that on a daily basis the average cash reserve is strictly according to the rules and does not fall below that level in any one week. The bank may get back its compulsory reserve only if it needs the refund on

conclusion of all its business or if it needs it to meet its financial obligations.

According to this rule, only 5% of the bank account will be considered adequate for its cash security. We are assuming here that under normal conditions the reserve along with cash deposited daily in the bank will be enough to meet demands for repayment out of the account.[1] In practice, most withdrawals will be from the loan account. In general, small amounts only will be withdrawn from the *muḍāraba* account daily or weekly and, in any case, the banks will be notified beforehand so that they can take necessary steps for the procurement of new cash according to requirements.

Most withdrawals from the *muḍāraba* account will be made at the end of the quarter or on those dates scheduled for the account audit. But new deposits will come into the *muḍāraba* account also on those dates and capital will also be received back from some of the business parties.

2 It will be compulsory for the banks to always be in the position to advance a fixed percentage of all the capital deposited in its loan account as loan. We propose that this fixed proportion should be 50%. We will hereafter use the term 'lending ratio' for this proportion.

It is not necessary that every bank should always advance precisely 50%. If the bank so desires it is entitled to advance loans up to higher amounts. But, as the banks will not benefit from these loans, it is much more likely that they will not advance more than they must in accordance with the lending ratio. But in view of the temporary nature of such loans and the securities required against them and the rules and the regulations for their repayment, it is probable that in spite of their being interest-free, demand for them will, under certain circumstances, be less and businessmen will prefer to take out capital on *muḍāraba*.

To ensure compliance with this rule, the daily average balance

[1]In the last chapter we assumed that if the banks kept 10% of the total of their accounts as reserve, they would be able to meet demands for cash from the public. Here we have added that half of the reserve of 10% will be deposited with the Central Bank as will be evident from the discussion following. As needed, other capital, in addition to their own cash holding, will be available to the banks from the Central Bank.

between loan accounts and loans advanced will have to be watched carefully. However, it will not be essential that the balance on any individual day, taken separately, should be strictly according to this rule.

3 When the commercial banks need additional capital besides their own cash for meeting their customers' demands for cash, they may present certificates of the loans advanced by them to the Central Bank in order to draw loans. These loans will be temporary and will not exceed a fixed percentage of the loans advanced by the bank. This percentage, namely the proportion between loans obtainable from the Central Bank (which includes bills of trade) and the loans advanced by the commercial banks, will hereafter be referred to as 'borrowing ratio'. We propose that this ratio be 25%. Such borrowing from Central Bank will be allowed to the commercial banks only in the event of unexpected demands on them for cash and not in the event of any failure on the part of the commercial banks especially regarding an increase in the reserve ratio. Initially, this loan will be advanced for a very short period, e.g. one, two or three weeks but the period might be extended if demands for cash do not level up. Thus, in principle, such borrowing is for very short-term purposes and may not be used by the commercial banks to expand their business. Most changes in the public demand for cash are by their nature a short-lived phenomenon. Should there be a permanent increase in the demand for cash, the Central Bank will deal with it by supplying additional cash to the entire banking system against which it may arrange to purchase shares (see below).

4 The Central Bank will have power to vary borrowing ratios for loans advanced against bills of trade: thus, for example, loans to agriculture may be fixed at 30% as against 20% to the cotton business. This will enable the Central Bank to influence the trend of investments and keep expansion of credit facilities in specific areas of capital investment in its control.

5 The Central Bank will also have power to sell and to purchase commercial shares. We will explain below how these regulations and an amendment to them will enable the Central Bank to control the business of commercial banks and the availability of capital. The Central Bank will alter the reserve ratio in order to keep the

credit creation capacity of the banks in its control and influence their liquidity position to bring about, as desired, an increase or decrease in the total supply of money. The Central Bank may, where possible, deal with circumstances arising from the cash demands of the public by varying the borrowing ratio strictly in accordance with the variation in public demand. In emergencies this change in borrowing ratio will be used to stop monetary growth or to decrease the supply of money. The general motive for varying borrowing ratios for different types of bills of exchange or against loans advanced to different businesses is to regulate the supply of loans to specific industries. This procedure may be adopted for *muḍāraba* capital also, to indicate the relative importance of various industries, and to direct investment in the economy on the desired lines. The Central Bank will make the purchase and sale of commercial shares a means of generating new cash to meet withdrawal demands on the banks, so that the function of decrease or increase in money supply is discharged effectively. The Bank may also aim at continuous growth in money supply in view of increasing demand for money in a developing country, when there must be a corresponding increase in the cash reserve. Variation of the lending ratio also aims at maintaining an equilibrium in long- and short-term capital for entrepreneurs. These points will be discussed in detail in the following paragraphs through examples.

It is worth noting here that the figures for lending and borrowing ratios, cash reserve and loans, given in the preceding paragraphs, are only examples. Actual ratios may be different from them. The discovery of suitable ratios will be possible only after the establishment of the interest-free banking system and practical experiment. The figures given in the examples are given only to clarify the general principle involved in these regulations.

It is also worth pointing out here that the steps taken to expand money supply are not as effective as the steps taken for its reduction. This is the case in the interest-charging system as much as in the interest-free system; more so in the latter because this limitation is dependent upon other causes and factors and not upon interest alone. The steps taken by the Central Bank to expand credit make it possible for the commercial banks to

produce new bank money. But in order to realise this possibility there must be a demand for new capital from entrepreneurs. If this demand is weak, expansion may be limited. By contrast, steps to reduce supply of capital will succeed simply by forcing the banks to withdraw their capital from businesses. Of course, banks would not be able to withstand the consequence of such a reduction for a long period. It is easier to shrink money supply than to expand it to counteract deflation. Furthermore, monetary measures to achieve either objective may have only limited success since, alongside these measures, some fiscal measures are also necessary.

Expansion or reduction of bank money, or credit, is fixed to expansion or reduction in the bank's cash reserve. Banks seek to maintain a proper balance between their deposits and the cash in their custody, and take steps (as we saw in the preceding chapter) either increasing or reducing the volume of their deposits to maintain the proper balance, the desired ratio. If the Central Bank wants an increase in the banks' volume of deposits it must enable the banks to represent more cash than, according to the reserve ratio, their actual deposits justify. Conversely, if the Central Bank desires a reduction in the volume of bank deposits, it will have to see to it that the banks are in need of additional cash in order to maintain the desired ratio. Cash reserve and borrowing ratios will be studied in the following paragraphs:

1 Changes in the Reserve Ratio

The history of modern banking shows that the original motive of earlier regulations regarding reserve was to protect the interest of account holders by ensuring the cash position of the bank. But the existence of these regulations has also provided Central Banks with an opportunity to keep the banking business and the supply of money under control. Such regulations are thus an important instrument of practical policy for the Central Bank, and we refer to them in this light.

What are the criteria for determining various reserve ratios for the commercial banks in any country? Of necessity this question cannot be answered in detail here. Apart from other considerations, the answer depends on whether the people prefer to

keep their money themselves or deposit it in a bank. But there has not been any sizeable change in people's habits in this regard – certainly no sizeable change within a short period. Therefore, for practical purposes, we may limit discussion to changes in the fixed and existing reserve ratio. These changes are made by the Central Bank to influence the cash reserve of the commercial banks and the supply of money by them.

If the Central Bank desires to restrict credit, it will introduce an increase in the reserve ratio which, ultimately necessitating the same increase in the cash reserve of the banks,[1] will oblige them to sell shares and withdraw a part of the capital supplied to businessmen in order to get new cash – especially as, under such circumstances, they will not be able to acquire loans from the Central Bank. As a result of the sale of shares and withdrawal of capital from businessmen, there will be a corresponding decrease in the volume of deposits at the commercial banks and the process of credit restriction will ensue.

If the Central Bank desires to expand credit in the economy it will reduce the reserve ratio. As a result some part of the existing cash held by the commercial banks will be 'surplus', and they will purchase shares and advance capital to the businessmen on *muḍāraba* in order to earn profit from the spare surplus.[2] With the

[1]Here it is being assumed that the banks have no surplus cash, but have only as much cash as is necessary according to the reserve ratio. As credit restriction is undertaken during a period of increased demand for capital, it may be safely predicted that, while taking advantage of increased demands for capital the banks will have supplied the maximum amount of capital on the basis of loan and *muḍāraba* and will not have any surplus cash. It should be noted that, to the extent that they have surplus cash the banks will not need new cash in spite of an increase in the reserve ratio and will not be compelled to withdraw capital from businesses. But their capacity to do this is very limited, and the Central Bank can increase the cash reserve to such an extent that the banks may be compelled to withdraw the capital.

[2]Here it is being assumed that there is demand for capital from businessmen. If due to recession in the market the demand is absent it will be difficult for the banks to make profitable use of their surplus cash.

It is worth mentioning that in an interest-charging economy a demand for cash from the banks is present only when the expected rate of profit from the capital investment is higher than the fixed rate of interest. In the interest-free economy the bank will become a partner in the profit of the business party instead of receiving a fixed rate of interest, irrespective of whether the profit is high or low. This means that the demand for capital from the bank on *muḍāraba* will continue while the expected rate of profit from capital investment is sufficient to yield a share to the entrepreneur that equals his alternative earnings. As for the demand for loan capital, this will depend upon the demand for *muḍāraba* capital in our proposed system and is an adjunct of it.

increase in money supply to businessmen additional money will be deposited in the accounts of the bank, and the process of expansion in credit will start.

Details of this summary with numerical examples are shown in the tables. The first indicates the process of contraction of credit. Suppose that at the beginning the reserve ratio was 10%, but the Central Bank raises it to 11%. It is, of course, obligatory for banks to deposit half their cash reserve in the Central Bank, but as this does not affect our examples, no division of the reserve is indicated in our examples. The effect of such an increase after completion of the process of credit reduction is shown in the second line:[1]

ASSETS			LIABILITIES		Total Supply of Money
Cash Reserve	Loan	*Muḍā-raba*	Loan Acct.	*Muḍā-raba* Acct.	
Rs.10,000	30,000	60,000	60,000	40,000	100,000
Rs.10,000	27,000	53,000	54,000	36,000	90,000

The difference between first and second lines may be explained like this: with the increase in the cash reserve ratio, the bank was obliged to increase its reserve by Rs.1,000 by withdrawing that sum from the capital advanced on loan and *muḍāraba*. There are various ways of doing this, which may be adopted simultaneously, e.g. the sale of some shares; calling in of loans advanced on the basis of repayment on demand; non-extension of the period of fixed-term loans and calling in capital advanced on *muḍāraba* when, according to agreement, it is overdue. Eventually, when the bank has withdrawn the sum of Rs.1,000 there will be a decrease by the same amount in its deposits. In other words, the amount of Rs.1,000 returned to the bank will be withdrawn from the bank in order to pay it out and in fact there will be no increase in the cash it holds. There will, however, be a reduction in its accounts. It will

[1] For the sake of simplicity in the table, amounts less than 1,000 have not been included. In fact the total supply of capital would be 90,909. Similarly all the amounts shown are little higher than the above amounts.

therefore need a sum of Rs.810 in order to meet the requirements of new reserve ratio and not Rs.1,000, due to this decrease in its accounts. The process will be repeated until it has withdrawn the additional capital. The process will require the bank to withdraw progressively smaller amounts of capital until, finally, no further withdrawals are necessary because by this time there will be a decrease of Rs.10,000 in deposits. A detailed statement of this is shown in the second line. The balance in the bank account has been maintained and the requirement of the new reserve ratio met. A summary of the process shows that the banks will try to obtain additional cash by withdrawal of their capital to meet the new reserve ratio. Instead of obtaining additional cash, however, as a result of decrease in their accounts it is rather the case that their cash holding will remain as before, but with the lower volume of deposits, meet the new reserve ratio.

The column of liabilities in the second line shows that the same ratio still obtains between the loan and *muḍāraba* accounts found at the outset of the process. The reason for this is our premise that when there are withdrawals from the banks they are at the rate of 60 and 40% respectively, from the loan and *muḍāraba* accounts. This premise was explained in the previous chapter. When the banks sell their shares, some of the people purchasing them may decide to do so with savings put by for investment in a profitable enterprise, i.e. from their deposits in the loan account. Others may decide to use the savings they had deposited in the banks' *muḍāraba* accounts to buy the shares, thus they will make withdrawals from the *muḍāraba* account. In this way if the bank calls in capital advanced on loan and *muḍāraba* to businessmen, business will contract and income decrease, which will ultimately affect both the current or loan account and the savings or *muḍāraba* account. As explained in the previous chapter, even if the premise regarding the ratio between the bank accounts is dropped, the process of reduction in the supply of money is unaffected.

The cash reserve in the column of assets in the second line is the same as in the first line, for reasons explained above. As we are considering the public demand for cash at a fixed point of time and, for the most part, the banks will not have received new cash from

the Central Bank, nor the Central Bank have withdrawn from them a part of the cash through sale of shares, there will be no increase or decrease in the cash held by the commercial banks. The capital advanced on loan is still half of the total loan account as required under the rules. The commercial banks will now be obliged to call in capital provided on loan according to these rules, but will be able to call in only such an amount as is permissible in view of the reduction in the total loan account.

Now, not only is the capital provided on *muḍāraba* less than before, but the percentage of reduction in this capital is greater than the percentage of reduction in the capital advanced on loan. This is mainly due to the fact that when the bank has to keep a bigger cash reserve, this affects even that part of the loan account which it might invest in profitable enterprises. The capital procured on *muḍāraba* was 60% of the total capital, and from the balance of 40%, 30% was allocated for advancement of loans and 10% for the reserve, but now (after the change in reserve ratio), only 59% of the capital can be used for advancement on *muḍāraba*. We must then conclude that an increase in the reserve ratio means a decrease in the supply of money and a corresponding decrease in both the absolute and relative volume of profitable enterprises of the bank.

A comparison of the first and second line shows that as a result of an increase in the reserve ratio there has been a decrease amounting to Rs.10,000 in the supply of money, or the bank money has been reduced by Rs.10,000, namely the volume of bank deposits has been reduced by 10,000.

If the Central Bank reduces the reserve ratio from 10% to 9% there will be an expansion in credit. This process may be understood with the help of the table below. The first line shows, as in the previous statement, how the account stands when the reserve ratio was 10%. The second line shows the position on completion of the phase-wise expansion of credit with the reserve ratio at 9%:[1]

[1] The amounts in the second line are less than they would be if accurately accounted. For example, the total supply of capital has been shown as 110,000 whereas it should read 111,111. The same is true of the other figures. This adjustment was made for the reader's convenience. The general principle and conclusion of our discussion is not affected.

ASSETS			LIABILITIES		
Cash Reserve	Loan	*Muḍā-raba*	Loan Acct.	*Muḍā-raba* Acct.	Total Supply of Money
Rs.10,000	30,000	60,000	60,000	40,000	Rs.100,000
Rs.10,000	33,000	67,000	66,000	44,000	Rs.110,000

With the reserve ratio at 9% the bank finds a cash surplus of Rs.1,000 – it tries to invest this in some profitable business and, given a demand for capital on *muḍāraba*, it does so successfully. Following this increase in the supply of capital to businessmen, additional capital is deposited in the bank's accounts. Even if the bank purchases shares to the value of Rs.1,000, the result is the same. The amount of Rs.1,000, received by the shareholders from the bank, will be deposited in the same bank accounts. The bank uses the balance of Rs.910 (having reserved Rs.90 against its new bank deposit) which results in a further increase in the volume of bank deposits, and if the demand for capital continues this process will continue also. However, the bank is able to supply less capital each time and a point does come where it cannot supply any more capital. At this point, the process of increase in the volume of bank deposits also stops. There has been an increase of 10,000 in the volume of bank deposits: its cash holding is now 10,000 which is 9% of the increased bank deposits standing at 110,000. An equilibrium in the bank account has been reinstated, and the requirement of the new ratio of the cash reserve has been met. In sum, the whole process is that the banks after a decrease in the ratio of cash reserve, discover cash surplus and supply it to businessmen; this results in an increase in the volume of bank deposits and expansion in the credit: the process stops only when all the surplus cash is included in the cash reserve.

In the second line of the table the same proportion is maintained between the loan and *muḍāraba* account as shown in the first line. This is due to our premise that when new capital is deposited in the

bank it is deposited in the proportion 40 and 60%. Even if this proportion is set aside the nature of the process of expansion in bank money remains unchanged. The cash reserve is still 10,000: we are considering public demand for cash at a fixed point of time, and there has been no increase or decrease in the bank's cash due to steps taken by the Central Bank. That is why there has been no change in the figure, but now it is 9% of the increased total amount of the bank deposits. The capital provided on loan is half of the current accounts as required under normal rules. Now, not only has there been an increase in the capital provided on *muḍāraba*, but the percentage of increase has been higher than the percentage of increase in the loan account. Thus, due to decrease in the reserve ratio the banks have been granted comparatively greater opportunities to invest in profitable enterprises, and we may therefore conclude that this method of expansion in money supply should be a source of greater profit to the bank.

We may conclude also that, in the interest-free system, the Central Bank can increase or decrease the supply of money by decreasing or increasing the reserve ratio, and it can, in other words, by controlling the reserve ratio, effectively control the total supply of money.

2 Change in the Borrowing Ratio

In general, people keep a small part of their money with them in cash and keep the rest in the bank. In what proportions they do this varies with national habits, the working of the banking system, and other permanent factors. Also, in response to some temporary factors the proportion temporarily increases or decreases; for example, on the occasion of festivals and in good weather people may need more cash in order to travel, or at certain times in the month, businesses will need more cash to pay salaries or wages. Such increases in the demand for cash can be anticipated, in the light of past and present experience.

Sometimes existing or expected changes in political and economic conditions may so influence the attitude of people as to cause an increase in the demand for cash. In some circumstances such a demand will be hard to predict. Such changes do occur

when people prefer to keep more or less of their money with them in the form of cash than in the past. To a permanent increase or decrease in the demand for cash, and the consequences of it, the Central Bank will respond by purchasing or selling shares, something we shall explain later on. Here we shall concentrate upon the situation which results from a temporary increase in the demand for cash. To run the banking system successfully, public confidence is essential – it is therefore also essential that in such circumstances the demand for cash is met.

As is evident from the above discussions, only a small part of the capital deposited in the banks (or as proposed by us, one tenth) is kept in the form of cash. The balance of nine-tenths of the capital remains in the form of entries in the bank's ledgers. In normal conditions the deposits made by the people daily and the banks' cash reserve are sufficient to meet the withdrawal demands for cash. But if the speed of withdrawals from the bank's accounts is faster than usual and the arrival of new deposits cannot keep up, the bank will only be able to comply with withdrawal demands if it receives additional cash from some other source.

As we have pointed out the commercial banks could keep a certain portion of their assets in a form convertible to cash without delay, as needed. These assets may, for example, take the form of loans repayable on demand or whose term is near completion, or take the form of shares that can be sold at any time without fear of loss. But this way out may be possible for only a few banks, it will not be possible for all banks at the same time. For if all the banks start calling in loans repayable on demand or start selling their shares, the people will not be willing or able (in view of their increased demand for cash) to supply the banks with cash; there will be a reduction in the volume of the banks' deposits and any effort to get cash will result in a reduction in the supply of money.

The only way for all banks to get additional cash is if the Central Bank is able to provide it. The loan regulations have been devised to enable the Central Bank to support the commercial banks in case of unusually high cash demand, to prevent their business from collapsing and to prevent any reduction in the supply of money. If the Central Bank fails to do this, the total supply of money may be adversely affected by increase (or by decrease) in the public

demand for cash. In view of the possible repercussions for the whole economy, it is most unwise to leave the total money supply to the mercy of variations in the state of mind of the people. The only appropriate and reasonable course is to manage it through the supervisory functions of the Central Bank.

By providing loans to the commercial banks, the Central Bank will make it safe for the people to keep any portion of their capital with the banks. In the overall economy this means that a part of the money supply which had hitherto existed in the form of entries in banks' ledgers will now be in the form of currency notes, and except for this change in form no other change will take place in the total quantity of money. The cash from the Central Bank will be transferred through the commercial banks to the people, and there will be a proportionate reduction in the banks' deposits. A reduction in the volume of deposits would imply a decrease in the supply of money, but there will not be a real decrease because an amount of cash equal to the decrease of bank accounts will remain in circulation among the people.

The Central Bank will have to satisfy itself that only that amount of loan is drawn by the commercial banks as is essential to meet the increased cash demand under the borrowing regulations and this facility should not be exploited as a means of getting new capital for the business community: the Central Bank may do this conveniently by proper supervision of the bank accounts. On the other hand, the Central Bank will also have to make provisions for an increase in the maximum amount which the commercial banks may draw as loans in order to meet the cash demand of the people under the loan regulations in force. As the Central Bank is empowered to issue currency notes, it will not have any difficulty in doing this. The people should be afforded the fullest opportunities to withdraw in cash any portion of their deposited money. There will not be any danger of inflation as a result of the acquisition of new currency notes for the banks' accounts so long as these new notes do not become a source of expansion in credit.

The loans advanced by the Central Bank will only be temporary and may be withdrawn as soon as cash demand returns to normal. Similarly, if an increase is considered necessary in borrowing ratio due to any extraordinary change in the cash demand, the

borrowing ratio may be brought back to its previous level on termination of the critical period. Thus the Central Bank can, in this way, maintain the liquidity of the commercial banks and the confidence of the people in them.

In emergencies a decrease in the borrowing ratio may be used to prevent the process of expansion in the money supply and/or to reduce it. However, such a step is justified only when, along with the increase in the demand for cash, there is inflation. Suppose that the amount of loan permitted to commercial banks under the regulations has been drawn by them, but the people's demand for cash has still not been met. Under these circumstances, if the Central Bank rejects the plea for increase in the borrowing ratio or even reduces it, the banks will be obliged to sell their shares or to call in capital advanced to businessmen. As explained above, a reduction in the supply of money is then inevitable and as a result, not only will withdrawal of capital from businessmen become a source of cash supply, but a reduction in the volume of banks' deposits will lead to a furthér decrease in the amount of loan from the Central Bank to which they are entitled. Thus the Central Bank will be able to bring about a change in the supply of money without changing the reserve ratio. This means of reduction will, however, only be effective under circumstances of heavy pressure for cash.

It is essential for the successful operation of any banking system that commercial banks can get loans without delay when the need arises – the source of such loans can only be the Central Bank. In the contemporary interest-charging system, the commercial banks draw a loan from the Central Bank or realise the same end through bills which can be sold via discounting in the bill market.[1] The Central Bank is always

[1]This procedure is specially evident in Great Britain. Some institutions transact the business of purchase and sales of government securities and some deal with the business of private securities. They procure the capital for this business from the banks, on the promise of payment on demand. The Central Bank is always prepared to purchase these securities from the above institutions or supply cash against them according to the fixed rate of interest with a discount. When the banks need cash they withdraw loans from these business classes. The dealers in securities refer to the Central Bank for the repayment of the above loans and repay their loans through discounts against the above securities. In America the banks may purchase the Central bank's loans or Federal Funds directly. In some countries like France and Germany banks can draw loans from the Central Bank on fixed interest.

prepared to advance loans to the commercial banks but, in order to discourage borrowers, may increase the rate of interest. As there is anyway a higher interest rate for such loans, and the rate of interest on the market is still higher than that fixed by the Central Bank, any increase in it will result in a further increase in the market rate of interest, and there is an ultimate reduction in the demand for loan from the banks. The Central Bank employs the interest rate as a means of reducing the money supply. Conversely when the Central Bank wants to make credit cheaper and easier it reduces the interest rate. According to our proposed regulation it will be possible for the Central Bank to increase or decrease the amount of loans to which commercial banks are entitled in need. But this will have no influence on the conditions for getting capital for business, because this capital is made available on the basis of profit-sharing and not on fixed interest.

For various reasons which we cannot go into at this juncture, an increase in the Bank Rate (the rate of interest charged by the Central Bank) has failed in modern times to appreciably reduce the amount or speed of capital investment. When profit returns are expected to be high, a 1% or 2% increase in interest rate does not diminish the demand for capital. This is why in various countries the Central Bank fixes a maximum credit limit or a quota for advancement of loans to the commercial banks.[1] Our proposed borrowing regulation is in practice equivalent to this procedure.

The main objective of monetary policy is to defend money supply from inflation and deflation, and to maintain it according to the needs of entrepreneurial activities and capital investment. What rate of profit is necessary in any enterprise to sustain its business has nothing to do with monetary policy. Keeping the supply of money under control through increase in interest rates openly challenges and inhibits any capital investment which will not secure profit returns greater than the increase in the interest rates. This is an unnecessary interference which should have no part in monetary

[1]This method is in practice in Australia, Belgium, Colombia, Costa Rica, France, West Germany, Nicaragua and Peru and its adoption is on the increase. See Peter G. Fousek: *Foreign Central Banking*, Federal Reserve Bank of New York, 1957, p.19.

policy. Our proposed system is free from such vices, being free from interest.

3 Preferential Use of Borrowing Ratio

Every bank will want to draw the maximum amount of loan from the Central Bank especially as it would be interest-free and enable the bank to maintain liquidity. Now if the Central Bank declares that it will advance loans at the rate of 50% of the investment in some particular industry or against bills encashed against such an industry, while the general rate is only 25%, the banks will favour loans to businessmen in that industry. Conversely, if the Central Bank fixes a rate lower than usual, let's say 15%, for a particular industry, the commercial banks will avoid advancing loans to that industry. As we have explained, the commercial banks should enjoy facilities for advancing loans to the business community: the Central Bank can encourage this by fixing different ratios for advancement of loan to different industries, in order to provide more loans in certain areas than in others.

The more easy availability of loans for certain industries will promote capital investment in them. Although such loans will only be short term the idea that it is easier to obtain them will lead to higher long-term capital investment (investment, that is, on partnership or *muḍāraba*). Availability of short-term loans ensures the profitability of an enterprise while, in any area of business where there are difficulties in getting loans, there will be less long-term capital investment.

The same principle, as applied to loans, applies to commercial bills encashed through banks. The encashment of commercial bills is synonymous with obtaining loans, and banks which encash commercial bills will therefore be able to draw loans under the borrowing regulations against these bills from the Central Bank. The Central Bank will, as before, fix different loan ratios for different commercial bills, so as to encourage expansion in some areas while limiting it in others.

The preferential use of borrowing ratio will prove to be a very effective means of increasing or decreasing credit expansion in

selected areas of the economy. The same purpose is served in various countries in modern times by fixing different rates of discount for different kinds of bills in various conditions by varying rates of interest on the loans advanced.[1]

If the Central Bank desires that no additional loan be advanced to any particular industry it can declare the borrowing ratio for that industry to be zero after a prescribed date. In other words it can declare non-payment of any loan to that industry. As there will be no income (in the form of interest) from loans to that industry banks will have no incentive for advancing loans to it.

Now as against an extreme example of zero loan ratio, the cent per cent borrowing ratio may also be considered. If extraordinary patronage or accelerated advancement is desired at any time a declaration may be made to advance cent per cent loan against loans to a particular industry. In such a case it may be expected that the industry would enjoy maximum benefit from its loan capital and, in spite of a limited supply of capital (as loans will be short term), demand will be to a large extent based upon the availability of long-term *muḍāraba* capital to that industry.

We should note that if the Central Bank fails to achieve the desired objective by restricting or easing the supply of loans to any industry, it may issue explicit instructions to the commercial bank. This will be a last resort measure, however, only to be adopted in extraordinary cases. Preferential borrowing ratio may also be used for the supply of loans advanced to the Government, and again for supply of loans to consumers: these points will be discussed in subsequent chapters.

4 Purchase and Sale of Commercial Shares

Under the above loan regulations supply of new cash to the banks depends upon their demand for it. The Central Bank will advance loans to them only when they demand it. Moreover, as mentioned above, under this regulation the supply of loan or the repayment of cash already procured will not, in normal circumstances, warrant a change in the total supply of cash. To make the

[1]Peter G. Fousek: *op. cit.*, pp. 20, 70, 71.

monetary policy of the Central Bank more effective some means is also required of providing cash to the entire banking system when the need arises or of limiting it. In an interest-charging system the Central Bank achieves this through sale and purchase of interest-yielding bills issued by the Government treasury over a short period to obtain loans. In an interest-free economy there will be no place for such interest-bearing bills. We are proposing that the same purpose can be served by government-issued commercial shares. The nature of these shares will be explained in the next chapter. Here we shall explain how the Central Bank can make the sale or purchase of commercial shares an instrument to serve this purpose.

The Government may issue commercial shares on the principle of partnership. The majority of shares will be in the ownership of the banks, other commercial institutions and the general public. If the Central Bank decides to purchase these shares, it may do so at the market rate or at a higher rate, and it will pay in cash. Given that people generally deposit their cash in banks this cash will ultimately reach the banks and a process of expansion in the supply of money and its commercial use will ensue. If there is a demand for capital in the business community the supply of money can increase manifold in the economy. Thus, the purchase of shares is an instrument for expansion in the supply of money, because it results in a supply of new cash to banks.

If the Central Bank purchases shares directly from the Government, the result will be the same in the end, because the Government will utilise this money for investment in business institutions in the public sector, which will in turn result in a rise in income in the form of wages, salaries and rents which will be deposited in the banks.

The Central Bank will always keep a considerable number of shares in its custody in order to make their sale an intrument for reduction in the supply of money. The Central Bank will always be able to sell its shares at the market rate or lower because banks, other commercial institutions and individuals, will be only too willing to buy them at reasonable prices. The banks and individuals who buy will have to pay for the shares in cash thereby reducing the cash reserves of the banks. If the purchaser is a bank

the cause of this reduction is directly evident, and if some other institution or individual, he will have to withdraw the money from the bank in order to pay the Central Bank or transfer it to the Central Bank through a cheque. The process of decrease in the supply of money will ensue and if, at the outset of this process, the banks were not holding surplus cash, the decrease will be manifold throughout the economy. Thus, the sale of shares is an instrument for the reduction in the supply of money because it results in a reduction in the cash reserves of the banks.

As we shall see in the next chapter the market rate for shares issued by the Government will depend upon expectations regarding their rate of profit. Although a fluctuation in that rate accompanied by variation in estimates of it is to some extent inevitable, it is, in the broadest public interest, necessary that it be protected against baseless speculations and the extraordinary inflations or deflations which are the result of such speculations. The Central Bank can do this by taking the requisite steps in good time for purchase or sale of these shares. The Government should keep the Central Bank fully informed of the activities of the business institutions run under its patronage with estimates of their profit or loss, based as far as possible upon genuine statements. The Central Bank will then keep an eye on the market price of Government shares in the light of these statements. If the price of the shares shows a decline not warranted by these estimates, it will purchase these shares at the market rate, thereby increasing the demand for them and defending their price. Similarly, if the price of the shares is rising too fast, the Central Bank will satisfy demand by selling shares at the market rate, thereby stabilising the price. The Central Bank should protect the price of these shares from extraordinary fluctuations so that wealth owners and the banks will consider them a relatively profitable capital investment, and it will then become easier for the Government to get capital from the general public on the principles of profit-sharing.

Alongside economic development and expansion in trade a continuous increase in the supply of money is inevitable. It is essential for a continuous increase in the supply of money that new cash is provided with reasonable speed to the commercial banks.

In our proposed system purchase of Government shares by the Central Bank is the source of procurement of new cash for the commercial banks. Apart from the day-to-day purchases and sales over the long term, the Central Bank can achieve a continuous rise in the cash reserve of the commercial banks by keeping the rate of share purchases higher than that of share sales. As the public sector grows and new shares are floated by the Government on a long-term basis, there will be a continuous increase in the supply of shares.

There are in sum three general objectives for the purchase and sale of shares: the supply of new cash to the banks to ensure continuous growth in the long-term money supply; to stabilise the price of Government shares against wide fluctuations; and to expand or contract the supply of money by injecting more cash into the system or withdrawing cash from it. These three objectives may not always be consistent with each other. It is conceivable that, to achieve one objective the purchase of shares is necessary, while another demands the sale of shares. In such a situation the contradiction may be resolved if the Central Bank, with all the three objectives in mind, buys shares or sells shares in conjunction with a change in the reserve ratio or a change in the borrowing ratio. If need be, however, the Central Bank can take certain other steps to remove the contradictions.

Supposing that market rates are falling due to some unfounded apprehensions and the Central Bank takes the necessary steps by purchasing shares, but does not intend, in doing so, any increase in the money supply. In such a situation it should make such an increase in the reserve ratio, in addition to purchasing shares, so that the cash received by the bank does not initiate expansion in the supply of money. If in these conditions the Central Bank wants actually to reduce the supply of money it should increase the reserve ratio accordingly, so that in spite of receiving new cash the banks are obliged to call in some capital.

In order to stabilise the price of shares and to achieve a desired reduction or expansion in the supply of money, both objectives should be borne in mind and carried forward simultaneously, on the pattern indicated above. As far as the question of supply of cash to the banks is concerned, this is a long-term objective, which

can be realised without much difficulty while at the same time protecting short-term interests. We would point out here that an increase in the cash in the economy can be achieved directly by the Government: purchase of shares by the Central Bank is not the only way to achieve it.[1]

Further, we suggest that the Central Bank should depend more upon changes in the reserve ratio (to expand or reduce money supply) than upon purchase or sale of shares. The latter strategy should be used only in those extraordinary circumstances where a change in the reserve ratio will not be sufficient for the purpose, or when the desired objective might be achieved within an extremely short period – for example in order to prevent some extraordinary inflationary trend. Even in modern times there is greater dependence in most countries upon a change in the reserve ratio for controlling the supply of capital than on the purchase or sale of bills. Some advanced countries like Australia and New Zealand can be included in this group.[2]

It would be appropriate to explain why we suggest that the Central Bank purchase and sell shares issued by the Government, when commercial shares are abundantly available to the market. The first reason is that from the Central Bank's standpoint the most stable shares are the most suitable and, in the market, prices of government shares will be the most dependable, we believe, because of the greater entrepreneurial prestige of the Government and its policy relating to profitability in public sector business institutions to be discussed later. Another reason is that the Central Bank has no rational criterion by which to select or reject shares issued by some of the commercial institutions. Extraordinary benefits may be enjoyed by businesses from the purchase by the Central Bank of a large number of shares. It then becomes easier for them to issue new shares and get additional capital. A preferential treatment of some businesses will be essential, and for

[1] If the government meets its expenses by obtaining loans from the Central Bank, there will be an increase in the quantity of cash in the economy.

[2] Commission on Money and Credit. *Monetary Management*, pp. 95, 104, 115, 119. R. S. Sayers: *Central Banking*, pp. 112, 120. Peter G. Fousek: *Central Banking*, p. 53.

Even in France, Italy and Norway, the Central Banks do not follow the procedure of purchasing securities on a large scale.

Economic Policy of our Time, Vol. 1, p. 70, Amsterdam, 1964.

this there should be some potential economic foundation. In the same way, if the Central Bank sells a large number of shares of some businesses, there is stronger possibility of a fall in their share prices and getting additional capital becomes difficult for them.

The proposition that the Central Bank will purchase more shares in the long run than it will sell, normally means that it will continue to provide the Government with more capital for investment. This capital is intimately bound up with the interests of the public sector, of society as a whole, and any preferential treatment of these interests will not become a source of resentment for any individual citizen. There are economic reasons in any welfare state for preferential treatment of industries operating in the public sector.

5 Changes in the Lending Ratio

In the proposed banking system individual entrepreneurs and institutions will be able to acquire capital for investment on long term on the principles of *muḍāraba* and profit-sharing. But, as clarified earlier,[1] some capital is always needed for the satisfactory running of the business in the short term, for which the principles and working of *muḍāraba* and partnership do not provide. This need can be met by short-term loans. A realistic proposition would be to base this demand for capital upon the size of long-term capital investment. Despite different ratios between loan capital and equity capital in different sectors of business, it will still be possible to find an average of the ratio between the two types of capital for the whole economy. For this ratio depends upon factors like methods of production, habits regarding storage of goods and the speed of sale of finished goods, in which there is less chance of sudden changes. Working out a ratio on the basis of past experience and analysis of the current situation, which provides a reasonable amount of loan to businessmen, will be another of the responsibilities of the Central Bank. When the Central Bank discovers a serious imbalance between long-term capital investment and short-term loans, due to which enterprises

[1] Chapter 4, Bank Loans.

are facing a crisis, it should deal with the situation through a change in the lending ratio.

If the supply of loans is lower than the long-term capital, and the loan requirements of the business community are not met, business activity will become sluggish and, in view of their unavoidable business needs, businessmen will be forced to resort to reduction in the long-term capital investment, to put aside a portion of that capital and divert it to meet temporary needs. From the standpoint of public interest this is not the best use of long-term capital – capital will have to be acquired for three months when it is in fact needed for only a few weeks. In these circumstances, if the Central Bank increases the lending ratio, the supply of loan will ultimately increase, although there will be a corresponding decrease in the supply of capital on *muḍāraba*. But as the period of the loan will be shorter than that for *muḍāraba* capital, it will be more profitable to utilise this capital.

An indicator of a significant decrease in the supply of loans in relation to demand will be the bank's inability to meet even those demands which they consider really important, and when they are forced to turn down a large number of loan applications. Conversely when the number of loan applications is small and the money available for advancing loans is in abundance, the banks will feel obliged to make loans from the funds available for that purpose, even when they think such loans unnecessary. This will indicate that the lending ratio is higher than actually needed and it should be decreased. The decrease in the lending ratio will bring about an increase in the permanent and long-term capital investment in the economy. Moreover, the resultant decrease in the supply of loans will force businesses to use the loan capital economically.

The regulations by which the banks should always be ready to advance a fixed percentage of their loan accounts was proposed with a view to facilitating short-term loans for individual entrepreneurs and institutions in spite of prohibition of interest. As we shall now explain it will also be possible to advance loans to consumers and to the Government under the same regulation, without which in the absence of interest, banks will have no incentive to provide this essential facility. The guiding principle for the determination of lending ratio should be that after meeting the

essential need for short-term loans, the maximum possible amount in the loan account can be utilised for profitable investment. The Central Bank would, naturally, make suitable adjustments in the lending ratio to ensure that the loan needs of individual entrepreneurs, consumers, business institutions and the Government are met.

A change in the lending ratio does not influence the total supply of capital or the overall total of the bank deposits. If we leave out consumers and Government, as we have done until now, this change does not even influence the total amount of capital made available to the business group. It does, however, affect the ratio between the loan and capital provided on the basis of *muḍāraba* as will be evident from the following statement:

The first line of this statement indicates the position of the comprehensive statement of account when the lending ratio is 50%. The second line shows 2½% increase and the third line shows the effects of a decrease of 2½%.

Lending Ratio	ASSETS			LIABILITIES	
	Cash Reserve	Loan	*Muḍāraba*	Loan Acct.	*Muḍāraba* Acct.
50%	Rs.10,000	30,000	60,000	60,000	40,000
52½%	Rs.10,000	31,500	58,500	60,000	40,000
47½%	Rs.10,000	28,500	61,500	60,000	40,000

The loan account, *Muḍāraba* account and cash reserve are not affected by the change in the lending ratio, which shows itself entirely in the figures for loan advanced and capital provided on *muḍāraba*. A comparison of the first and second line shows that an increase of 2½% in the lending ratio results in a decrease of Rs.1,500 in the supply of capital on *muḍāraba*. The third line shows a decrease of Rs.1,500 in the supply of loan as a result of a decrease of 2½% in the lending ratio, but with a corresponding increase in the supply of capital on *muḍāraba*.

We proposed earlier while discussing the borrowing regulations

that the amount advanced by the Central Bank to a commercial bank would depend upon the amount of loan that the bank advanced. Necessarily a change in the lending ratio would affect the borrowing permitted by the Central Bank. If the Central Bank does not want to change the amount it lends it will have to change the borrowing at the same time as the lending ratio. If the adjustment in the lending ratio is slight and the existing position does not warrant an adjustment in the borrowing ratio, this step may be postponed.

6 Use of Various Instruments

The analysis of the objectives of the Central Bank's monetary policy and of the methods for their realisation has shown the necessity of applying different methods simultaneously, for the most part, to attain a particular objective. For instance if, to combat high inflation, the Central Bank wishes to restrict money supply, an increase in the reserve ratio, a decrease in borrowing ratio for industries growing at a faster rate and the sale of shares may be undertaken simultaneously. Similarly, to combat deflation a decrease in the reserve ratio, an increase in the borrowing ratio for certain industries and purchase of shares can be undertaken together. Numerous instances might be given to show that, policy objectives relating to the supply of money, the ratio between loan and *muḍāraba* capital, and share prices can be balanced and effectively served by the simultaneous use of a number of instruments.

Our conclusion must be that, in spite of the prohibition of interest, the Central Bank can discharge all the functions typical of a Central Bank. Even in an interest-free economy monetary policy is a meaningful idea and it can be made to serve the demands of changing conditions.

The Central Bank will be established with Government capital. The cost of its management may be offset against profit earned from the sale of Government shares, but this income is neither guaranteed nor can it necessarily meet all the expenses. One of these two methods must then be adopted: the Central Bank must be considered an essential social service and its costs borne by

the State Exchequer and, as for other social services, sources of income should be established for this purpose. Alternatively, the costs could be met by the commercial banks. For this purpose, strictly according to the ratio of the business capital of the banks, an annual fee may be levied on them or a portion of their annual income charged from them. Thus, in principle the expenses of the Central Bank should be met by the Government. However, while raising money for this purpose, the Government may levy special taxes on the banking business.

CHAPTER 7

Banking System and Public Finance

The structure of an interest-free banking system outlined in previous chapters includes no reference to public finance, for without a detailed discussion of the expenditure and the income resources of an Islamic State, of its aims and objectives, and of the means it has for acquiring income, any description of public finance is bound to be inadequate. Such a task needs to be undertaken separately because justice cannot be done to it in the middle of a discussion of interest-free banking. There are, however, two issues pertinent to public finance that are so closely interlinked with money and banking, that their introduction is essential at this stage: obtaining, on the State's behalf, capital on *muḍāraba* or partnership and obtaining, on the same behalf, capital on loan.

The policies of the Central Bank regarding money are, in any country, subordinate to the major objectives of the State and formulated with those objectives in view. The working and regulations of the Central Bank become more complicated when we consider them in the context of the State's economic policies, particularly its major objectives. After analysis of the two issues mentioned above, we will be in a position to define some of the new responsibilities and functions of the Central Bank.

As the Islamic State is an institution with a purpose, its expenditure needs should be determined rather by its objectives than anything else. Of course it will need sources of revenue. To limit discussion somewhat we can assume that, like other modern states, an Islamic State would use the various usual means to build up its financial resources, including taxation, transaction of profitable business, procurement of capital on the basis of

muḍāraba and partnership and borrowing. The need for financial resources and the necessity of exploring all the above-mentioned avenues can only be mentioned here briefly. However, in this context, the dominant factor must be the economic responsibilities of the Islamic State, which have already been discussed at length separately.[1] The outcome of that discussion is that the Islamic State would guarantee the basic needs of all people resident in its territories up to a reasonable standard: it would see to it that food, clothing, housing, medical treatment and education are provided to every individual and it will secure his life, honour and property from any kind of high-handedness. The Islamic State would develop the country economically and socially since none of its other responsibilities could be discharged without doing so. Another important responsibility is to reduce the inequality in the distribution of income and wealth within the society. Moreover, the Islamic State being a representative institution would try to meet those collective public needs which are increasing in modern times.

General economic development, as required by modern welfare states, will be the aim also of the Islamic State, the more so as its objectives are linked with social and economic well-being, and social stability. In addition to and in combination with this the Islamic State would introduce spiritual and moral training, seek to promote good and to eliminate evil, to develop the individual personality, to protect its conscience and freedom, to defend it against all exploitation, and seek to establish a clean and orderly society. To realise these laudable goals, the State will, as well as other means, use banking and finance.

The Islamic *Sharī'a* does not restrict State revenue and, depending upon the situation and circumstances, there are ample opportunities and means for its extension.[2] Rather than discuss the well-known sources of revenue, we shall discuss the fact that the State would need loans from the people as well as capital on *muḍāraba* and on the basis of partnership.

[1] 'Islāmī Riyāsat Kī Ma'āshī Dimmedāriān', in *Islām Kā Nazariya Milkiyat*, Vol. 1, pp. 91, 100: Islamic Publications Ltd., Lahore.

[2] For a discussion on the subject see: *Islām Kā Nazariya Milkiyat*, Vol. II, Chapters VII, VIII, XI & XII: Islamic Publications Ltd., Lahore.

State Expenditure and Sources of Revenue

The general expenses of the Government should be met from the tax revenues: expenses such as civil administration, judiciary, legislature and maintenance of law and order in normal conditions as well as the maintenance of the defence services. Also for the provision of some of the basic social services, e.g. education and health, the funding should come from the tax revenues. The expenditure on economic development and social needs assigned to the State by society is not, however, to be met from ordinary revenues.

The basic needs of the people should be funded from the income of *'ushr* and *zakāt*. Expenditure on account of preaching of Islam by means of radio, television, films, etc., and also for promotion of good and eradication of evil should be met by the funds raised under *Sharī'a* laws and from additional sources of revenue.

National economic development requires massive financial resources which cannot be got simply by levying taxes, although taxes are an important source of revenue; some income can be derived from State properties and production and profits from State-sponsored trades and industries. But in modern states, especially the under-developed countries, it is very obvious that the income so derived is inadequate. It is therefore imperative that some part of the people's savings be procured on *muḍāraba* or partnership a well as on loan for the development schemes.

In the context of planning for development, importance attaches to releasing factors of production like land, labour and machines, etc. from production of consumer goods and shifting them to the production of capital goods in those industries capable of creating a base for manufacturing machines, instruments and apparatus for producing consumer goods. A vital corollary of acquiring some part of the people's savings on loan or on *muḍāraba* or in the form of taxes is that it reduces purchasing power and the demand for consumer goods, which in turn leads to release of some factors of production and their deployment in development projects. If this is not done, it is possible that most resources will remain for the present engaged in production of consumer goods and major economic development in the country

will not be possible through lack of long-term capital investment. As social and economic development is an important responsibility of the Islamic State, it will have to adopt all fair methods essential to discharge that responsibility. In time of war the State treasury may not be able to meet defence expenditure needs, and it will require the financial co-operation of the people; the needs will not be served simply by an increase in taxation, the more so as taxation beyond a certain limit gives rise to a whole host of political, social, economic and administrative problems. The State should appeal for donations as well as borrow from the public.

The State may need a loan to meet some temporary need. Generally the State's income goes up sharply in certain weeks of the year as compared with the year overall. These special weeks are those when *'ushr* and other taxes are recovered. Most of the State's expenses by contrast are spread out evenly over the whole year; for example, employees' salaries and wages. To cover its daily needs the State treasury will sometimes need a temporary loan. This situation is faced by every modern state and some countries have to issue treasury bills to acquire the necessary loans.

In addition to serving temporary needs, obtaining loans from the public is an important means of controlling effective demand – and is sometimes used exclusively for that purpose. Generally the means is used, together with increased taxation, to prevent inflation, and especially when increased taxation has failed to achieve the desired result. In other circumstances, when the State considers an increase in effective demand desirable, it can float money into public hands through repayment of loans. There is no reason why the Islamic State should not also use this instrument of public finance, and it constitutes one justification for the State to obtain loans.

To students of public finance and economics, the reasons why the State has to acquire loans from the public or procure capital on *muḍāraba* will be known. It is worthwhile adding here that there is no bar under *Sharī'a* law to prevent the Islamic State from acquiring capital on loan or on *muḍāraba*. No injunction in the Qur'ān nor in the *Sunna* prohibits it, nor have researches

discovered any rules that might require such a prohibition. On the contrary, there are examples in the *Sharī'a* of practical steps to be taken for obtaining loans, and scholars of Islam have clarified the situation by stating that circumstances can arise where the Islamic State will need loans. For the Islamic State there are instances of land allocation on share-cropping and supply of capital from the public treasury on the principles of *muḍāraba*.[1]

There is also an established procedure when the State is in financial need, for the creation of new money or deficit financing. When expenditure is higher than revenues together with capital obtained from the people on loan or *muḍāraba*, the deficiency is met through the creation of new money. The consequent increase in money supply causes a temporary rise in the price of consumer goods, i.e. the purchasing power of the money against goods and services is reduced, and the State can thereby acquire some quantity of consumer goods, an objective which, in certain circumstances is impossible by any other means. Deficit financing works like a tax affecting the poor and rich alike. If the State makes use of the new capital for a project that within a relatively short period of time, brings about renewed supply of consumer goods, prices may revert to their previous level and money recover its purchasing power. In underdeveloped countries deficit financing is used to help development and reconstruction projects. But practical experience shows that good results are not achieved in these countries and prices do not revert to their normal level. Another reason for rejecting this method is that when commodity prices rise, the income of certain sections of the society also rises and they derive extraordinary advantages from the situation, whereas other sections are faced with extraordinary difficulties. This hardly satisfies the need for social justice. Therefore the method is to be adopted only in extremes: when some natural calamity or war or other exceptional circumstances warrant its use along with other measures.

[1] *Islām Kā Nazariya Milkiyat*, Vol. II, Chapter IX.

Procurement of Capital on Partnership or *Muḍāraba*

There are some important public sector enterprises and development projects where it is possible and right to use capital got from the public on *muḍāraba* or partnership; and there are others where it is not feasible and not right. Where the products of the enterprise can be sold on the open market or, in the case of raw materials, where the enterprise supplies essentials for the making of products which can be sold on the open market, the use of capital got on *muḍāraba* or partnership is legitimate. But not so for those State enterprises (e.g. atomic energy, arms and munitions manufacture, large irrigation works, hydro-electric power projects, most schemes for transport and communications) whose products are not sold on the open market: such enterprises provide important social services whose price is determined on grounds other than profit and loss. By contrast, the spare parts industries, electrical goods, watches, radios, televisions, motor cars, agricultural machinery and appliances, factory plant, as also those heavy industries which require long-term investment and considerable time before reaching full production, e.g. steel, copper, aluminium and other metals and minerals, petro-chemical industries and diverse others, all satisfy the requirement that their product can be sold on the open market, though they do pose some problems regarding calculation and distribution of profits in view of their long-term nature.

For capital investment in the national industries on principles of partnership or *muḍāraba*, it is essential, if the people are to entrust their savings that their investment be repayable after a reasonable period, and that they may justifiably expect a reasonable return upon it and that there be no more risk than attends investment on the basis of partnership or *muḍāraba* in the private sector. If an Islamic State succeeds in establishing such a system of capital investment with these qualities, it is hoped that it would be able to mobilise capital, from individuals and institutions, on a huge scale. In our view, it *is* possible to establish such an institution, and there is no reason why the Government could not do so.

We have already explained in detail the difference between partnership and *muḍāraba*, and keeping this difference in mind we

propose two corresponding ways of getting capital from the people for the State, the first dependent on *muḍāraba* and the second on partnership. As will be explained later, variety in the form of investment will facilitate mobilisation of investible funds.

Government *Muḍāraba* Shares

In the Islamic State the Government should procure capital for investment in enterprises in the public sector by issuing a number of shares of fixed value for a fixed period. For example, shares of the value of Rs.1,000 or Rs.10,000 or Rs.100,000 might be issued. Every share will bear the date upon which the capital it represents will be repayable with profit or loss. This date may be fixed at six months, one year, two years or five years and so on. Every share will also carry the conditions that whatever profit accrues will be shared by the State to the extent of one-third, one-fourth or a half, with the balance going to shareholders. If the enterprise concerned results in a loss, the capital will be reduced proportionately at the time of its repayment. (We have already explained the relevant principles in the discussion of the *Sharī'a* laws which govern them).[1] How the profit or loss on the capital invested by the State is to be worked out was dealt with in the earlier chapters. The State will arrange yearly or half-yearly audit of its enterprises and the profit or loss of the shareholders will be accounted at this time: the procedures for the sharing out of profit or loss were also explained in earlier chapters.

It would be better if the sharing out is done yearly or half-yearly, even when the term of the shares is longer. For example if the shares are for one to ten years, and the enterprise concerned has made a profit, the share of every shareholder should be paid to him after the annual audit; in case of loss the shareholders should be informed that their capital has been reduced accordingly and they should not be asked to make up the loss. On completion of the term of any share, its profit should be worked out in view of the annual statement and paid to the shareholders along with profit or after deduction for any loss. Where the term of the enterprise coincides

[1] In *Shirkat aur Muḍārabat kē Shar'ī Uṣūl*, Islamic Publications Limited, Lahore, 1969.

with the term of the shares in it, auditing will be easier, but even investment of shares of different terms will not present any extraordinary complication.

Every year the Government should issue new shares on *muḍāraba* which would be sold in order to mobilise new capital, and simultaneously the Government should refund the capital procured through older shares that have completed their term. Efforts should be made to ensure that the capital produced by the new shares exceeds the capital to be refunded so that public sector enterprises may continue without shortage of capital. In a developing economy the success of this effort is certain especially where the State has earned public confidence by running some public sector enterprises successfully. To this end the State should pay special care to the problems of expenditure on administrative and bureaucratic machinery.

If in some years the demand for Government shares on *muḍāraba* is low and enough new capital cannot be got the State can adopt various remedies. It can change the ratio of profit-sharing so that new shareholders draw a higher percentage of profit than they might previously have done. A second measure may be to make income from profits on Government shares of *muḍāraba* either partially or wholly tax-exempt. As this concession will not extend to investment in the private sector we can anticipate that would-be investors will prefer investment in Government *muḍāraba* to other areas of investment.

It is important not to forget that the risk of loss will not of itself inhibit the demand for *muḍāraba* shares because due to prohibition of interest in the Islamic economy there will be no alternative investment in which there is not some risk. The impediment to the procurement of capital for public sector enterprises on the basis of partnership and *muḍāraba*, is not the risk of loss itself but the possibility that the risk is greater than in the available alternatives – depositing in *muḍāraba* or loan accounts in banks or purchasing shares in private enterprises. If would-be investors in Government shares are confident that they are not running greater risks than they might run elsewhere, they will ultimately prefer to invest in the public sector. It is our belief that publicly-owned industries can be run in a way that not only

competes well with the private sector, but makes the risk of loss purely theoretical, and in which no investor will ever experience a loss in practice. Given no loss in practice, the decisive factor will then be the rate of profit, but the uncertainty about the amount of profit is preferable to uncertainty about whether there will be profit at all. In the absence of danger of liquidation of invested capital or of reduction in it, the prospects for procuring capital for the public sector are reasonable. However, the prospects become very bright if, for a continuing period of years, the Government establishes a record of good administration, prevention of irregularities, containment of bureaucratic expenses and, on top of that, promptly refunds capital with all due increment. The natural fears and doubts of the public before an experimental system of interest-free banking should fall away and gradually the system will have been proved to be soundly based and soundly run.

Our belief that no risk attends Government *muḍāraba* shares is grounded upon the fact that industries expanded by the Government produce goods for which the demand in a developing economy can only increase. Steel, cement, machines and spares, agricultural implements, electrical goods etc., are obvious examples. Except in the event of lack of planning when supply exceeds demand continually, the possibility of a fall in the price of the goods produced is very remote indeed. Furthermore, although the produced goods are sold on the open market, the Government as the sole or largest producer, will be able to regulate supply and influence prices to a certain extent. In determining price, the Government should calculate for a reasonable profit after meeting production cost. A workable policy would fix the price so as to ensure investors a better return than might have been possible on investments on *muḍāraba* in similar enterprises in the private sector.

The experience of various countries shows that governments can attract capital to the public sector on a fixed rate of interest, and despite the increased costs due to interest can run Government enterprises at a profit, thus ensuring further investment. There is no reason, given its strong influence on prices, why the Islamic State should not be able to run its enterprises profitably on *muḍāraba* capital and continue to attract

further investment.[1] In practice, the only difference between purchasers of Government *muḍāraba* shares and those advancing loans on interest is that the shareholders' rate of profit will neither be predetermined nor constant but will increase or decrease each year. But just as, in practice, the risk of loss can be removed, so too excessive fluctuation in profit rates can be prevented so that there are neither wildly high profits nor wildly high losses.

The holders of *muḍāraba* shares will have no say in the policies or running of the business in which they have invested. However, shares issued in the name of a particular enterprise must be invested only in that enterprise and no other. The Government will not have power to make any change in the nature or policy of the enterprise, which is detrimental to the shareholders' interests. If the national interest requires such a change, shareholders must be duly notified and afforded an opportunity to withdraw their capital should they now decide to do so. Public sector enterprises established through the capital raised by Government *muḍāraba* shares will be the property of the nation, not the property of the shareholders. Their position will be that of investors in a running concern under the management or directorate of the enterprise.. The only proof of their position will be the deed issued to them at the time of purchasing the shares. Names and necessary particulars of all purchasers of the Government shares will be entered in a register. The certificates, which we call Government *muḍāraba* shares will be sold to individual members of the general public and to business institutions. On completion of the term of a share, the capital will be repaid to the purchaser or his next of kin or successor on his death. The same procedure will be followed for the distribution of annual profit.

Government *muḍāraba* shares will not be sold on the market, but through institutions like the State Bank, Post Offices, Government Treasuries, and will be sold by Government staff. Purchasers of these shares will not have right of transfer or re-sale or exchange. This precisely is the nature of the *muḍāraba* deed. Holders of *muḍāraba* shares are not proprietors of any part of the

[1] Assuming a loss in some years, a Reserve Fund might be established by keeping back a percentage of profits; then, in times of loss, though not making a profit, shareholders capital need not be reduced. Reference to this possibility was made in Chapter 3.

enterprise in which their capital has been invested. The share certificates are not an authority of ownership of *muḍāraba* but proof of supply of capital. This nature of *muḍāraba* share distinguishes them from Government partnership shares explained below.

Government Partnership Shares

As we made clear earlier, the party whose capital is acquired on the basis of partnership must be given a say in management, even though that party may choose not to exercise the right in practice. This distinguishes the partnership and *muḍāraba* shares; it follows that businesses run on partnership shares become the joint property of the partners, and that partnership share certificates are an authority and proof of partnership and ownership. Thus, if the Government starts an enterprise with ten million rupees and this capital is obtained by selling 100 shares of Rs.100,000 each, the owner of each share will be considered the owner of 1/100 part of the whole. The fact of ownership and say in management is critical, and it is of the utmost importance that the Government keeps it in mind when issuing partnership shares.

Supposing that the Government wants to start an enterprise with capital of 10 million rupees, for which it issues 100 shares of Rs.100,000 each, of which it purchases 60 itself and the remaining 40 are purchased by banks and individuals. In other words an investment of Rs.6,000,000 has been made by the Government and Rs.4,000,000 by others. The responsibility for running the business and formulating important policies and programmes is entrusted to a board composed of ten members, of whom six should be appointed by the Government and four elected by the shareholders. There are various appropriate ways of doing this which we cannot go into in detail at this stage. Although the whole enterprise is a joint venture, Government representatives should be in a majority in its administration. In our view this point is of vital importance. To ensure that public sector enterprises serve the national interest, it is essential that in spite of the partnership of the private sector, only the representatives of the national interest hold key positions. This objective can be achieved legitimately

only when, in the national industries run on partnership capital, the Government has a majority share.

The decision making procedure of the board should be clearly worked out at the outset: which matters would require a two-thirds or three-quarters majority, which a one vote majority, and so on. The necessary rules and regulations should be clearly framed so that, while the ordinary shareholders have a genuine share in the running of the enterprise in their own interest, that interest should never undermine or weaken the national interest.

Obviously the financial administration should be such that the liability of the shareholders does not exceed the amount of capital provided by them: i.e. there should not be any investment of long-term loan capital, and even the short-term loan or credit transactions should be made within the scope of the total capital. But if in some industry a large investment of loan capital becomes necessary along with partnership capital, then it will have to be permitted: in this case, however, the financial liabilities of the shareholders are unlimited and they should be made aware of this.

It would be appropriate to issue partnership shares for a fixed term: shares of different value for different terms will attract capital from long-, short- and medium-term investors.

Government and partners must determine what dividend will be paid out of profit accrued on the shares. Profit may be divided in proportion to capital investment, but there is no compulsion to do this. In our view when partnership capital is obtained for Government-sponsored enterprises, less of the profit should go to the ordinary shareholders and more to the Government. Continuing with the example above: three-quarters of the profit on their capital may be divided among the 40 ordinary shareholders so that from a total profit of Rs.100,000 the shareholder whose Rs.100,000 has in fact earned Rs.1,000 will get only Rs.750, the remainder going to the Government which will then get, on every share of 100,000, a profit of Rs.1,166. It is perfectly legal under the *Sharī'a* for different rates of profit to be fixed for different partner shareholders. As we have elsewhere clarified,[1] the reason for this is to provide for the different contributions (work, expertise, etc.) of the different partners. In the present case it is clearly the Government that shoulders the major (if not the whole) responsibility for the practical running of the business: it follows that a higher share of profit may be fixed for the Government than for the ordinary partner-shareholder. As regards liability for loss, however, this must, of course, be borne according to the share of capital invested in the enterprise.

The dividend rate payable, of the enterprise profits, must be clarified at the outset: the loss if any will reduce the capital of each investment proportionately. This information must be given on the share certificate, as well as if the financial liability of the investor is limited or unlimited and for what enterprise (where this is specified) the share is issued. Profits may be distributed as for *muḍāraba* shares and on completion of the term. The capital should also be refunded, with the increase or decrease, at the end of the year.

As every share certificate is a document of ownership of a part of the enterprise, it may be sold on the open market. Every shareholder will be at liberty to sell his shares, but only those shareholders will be entitled to share in the distribution of profit or in elections for the board who hold the shares at the time of the year when the distribution of profit or the election normally take place. Transfer of ownership must be indicated to the Government so that it may alter its registers accordingly.

Shareholders will not, when selling Government partnership shares be bound by the price of the share entered on its certificate. A share of Rs.100,000 may be sold or purchased at more or less than this value: every owner has the right to sell in this way. The critical factor in determining the share's market price will be the profit dividend expected from it. The price will vary according to whether a high or low profit is expected, which in turn will depend upon the efficiency of the enterprise concerned and also upon the stability of share prices in general. Fear of loss in the enterprise will of course bring down the share price, possibly below its original level. It is also to be expected that share price will fluctuate when the time of profit distribution approaches, according to speculation, while, during the rest of the year, it remains relatively stable. The behaviour of partnership shares on

[1] *Shirkat aur Muḍārabat kē Sharʻī Uṣūl*, pp. 36, 38.

the market will be typical of share markets everywhere in modern times.

The Government's prestige, its policy and organisation for the profitability of its enterprises, will (as we have discussed above) guarantee a greater consistency in these shares. Clearly though, the price of shares on the market will be vulnerable to speculation and estimates. A detailed discussion of this important problem is beyond the scope of the present volume. But we point out the need to allow the fullest freedom to individuals to base the price of shares, as with other properties and commodities, on market estimates. On the other hand, anyone deliberately seeking to profit out of fluctuations in share prices should be discouraged. The Central Bank can (as was explained in the preceding chapter) help to maintain share prices, to defend them against extraordinary fluctuations.

Because Government partnership shares are likely to be profitable and therefore always saleable, they will be a source of profit to banks and other institutions, as well as to the individuals who have invested. Commercial banks, and those individuals who want to earn profit on the savings they have accumulated by making short-term investments, will be attracted to Government partnership shares. If our argument is good, profitability is virtually certain though variable in amount. Shareholders may, just as they wish, sell their shares or hold on to them until prices rise. A deficit against the capital invested is not likely to happen, although theoretically conceivable. As several institutions of great reputation have demonstrated the security and profitability of their enterprises, there is no reason why an Islamic State should not be able to do so also and, thereby, attract investment and maintain its share prices at a high level.

We suggest that the size and the term of Government partnership shares be fixed at a higher level than Government *muḍāraba* shares which would be more conveniently designed for the small investor. The partnership shares should be utilised to get relatively large amounts of capital for long-term investment. Moreover, the principle of dividend distribution should be so devised that in case of profit the partnership shareholders receive a higher dividend than *muḍāraba* shareholders: say, three-quarters of the profit for

partnership shareholders, if half of the profit is paid to *muḍāraba* shareholders. But *muḍāraba* capital should be invested in those industries and enterprises whose security is relatively greater. These provisions will ultimately ensure the availability of various types of shares in the market and give choice of investment to both the small and large savers, to individuals as well as banks and other financial institutions, to suit their particular interests and temperaments.

There are in sum three major differences in principle between the partnership and *muḍāraba* shareholders. Firstly, the purchasers of partnership shares will have an opportunity to take part in the management of their respective industries through their elected representatives, whereas the purchasers of *muḍāraba* shares will have no such opportunity. Secondly, the purchasers of partnership shares will be able to sell their shares as and when they wish, whereas *muḍāraba* shareholders will have to wait till the completion of a stipulated period for the refund of their capital. Thirdly, partnership shareholders will, in the event of profit, get a higher percentage of dividends on their capital than the *muḍāraba* shareholders. There is yet another difference, though not of principle – namely, that *muḍāraba* shares will be issued for shorter terms and for smaller amounts, whereas, according to our suggestion, partnership shares will be in larger amounts and for longer periods of time. It is quite possible that this may not be considered suitable and they may also be issued for smaller amounts and for shorter periods.

The sale and purchase of Government shares by the Central Bank mentioned in the last chapter refers of course to Government partnership shares. The Central Bank may also buy *muḍāraba* shares issued by the Government, but it will not be able to sell these to the general public and may only get back its share capital from the Government on completion of the term of the shares. The number of shares in the custody of the Central Bank will go on increasing in order to get new capital for the economy against any increase in the supply of money; it may purchase a number of *muḍāraba* shares and on completion of their term purchase further shares and in this way maintain a large number of *muḍāraba* shares in its custody. Most probably the shares it

intends to sell as the need arises will be partnership shares.

The investment of a large amount of capital by the Central Bank in the Government shares of partnership and *muḍāraba* is equivalent to channelling a large amount of capital into investment in the public sector. Obviously if this entire capital has been created in the form of new money, namely the Central Bank has printed new currency notes to purchase shares, the activity will be a form of deficit financing. If, however, the capital deposited in the Central Bank in the form of the cash reserve of the commercial banks is used for this purpose, this may not be considered deficit financing because the cash reserve of the commercial banks represents a part of the savings of the people, which has reached the Central Bank indirectly, and its use in this way will not therefore be synonymous with an increase in effective demand.

An increase in the supply of money to enable the Central Bank to purchase shares will be appropriate only in view of ever-expanding demands of the economy for new cash. But as there will be an increase in productivity as a result of capital investments in the public sector, there is less chance of these hazards which must be borne in mind regarding deficit financing and against which precautionary measures must be taken. The money received by the Government from the Central Bank in payment of shares should be used for assets like factories, machines, raw materials and manufactured goods, and where the increase in the supply of money corresponds to an increase in the supply of consumer goods, inflation cannot occur.

Government Loans

As we pointed out earlier, some industries in the public sector are such that capital procured on the basis of partnership and *muḍāraba* cannot be invested in them. They must therefore be run on Government or national capital. These industries are critical for the economic development of the country and the pace of that development depends to a very great extent upon their stability. Atomic energy, irrigation schemes, transport and communications projects are examples: in addition industries connected with the military and defence services and needs can be run only

on national capital. The capital needs of these industries grow rapidly and very often it is not possible to depend on tax revenue alone. All modern states have to resort to loans from the people for this purpose. The Islamic State will also need long-term loans to meet the development needs of the people.

When the country is faced with an extraordinary event like war or some natural calamity, efforts should be made to get the financial cooperation of the people on, as far as possible, a voluntary basis, and as far as possible additional taxes should also be levied. But it is unrealistic to suppose that needs can be sufficiently met by these means. The Government will have to get loans repayable in the future from taxes and other sources of income. Thus, instead of putting the burden of the war or calamity on a few wealth-owners for a short period, it should be spread over a long period and future wealth owners should also be provided with an opportunity to participate in the work – which arrangement comes nearer to satisfying the demands of justice.

For certain of its needs, the Government will require short-term loans, just as the private entrepreneurs do. The commercial institutions sponsored by the Government will also need such loans, as will the Treasury whose expenses are spread out over the year but whose income is not.

For short-term loans the onus of their procurement can to some extent be placed on the shoulders of the banks, where large sums of money are deposited against the loan accounts of the people. Thus the Government's short-term needs may be met from short-term loans from commercial banks – the practical application of the procedure will be explained later.

The Government will be responsible for repayment of the capital loaned by the people, after a fixed period, but no interest or profit will be paid on this capital.

The question naturally arises what incentive is there for the people to lend to the Government. A related question is what the Government must do if it needs to increase the supply of loans.

The defence of the country, building up its military strength, and economic development and reconstruction, are important social objectives, important for an Islamic State. The more conscious individuals are of the religious nature of these objectives

and of their special importance, the more inclined they will be to serve these objectives and sacrifice their immediate interest to the community. The Islamic State must work to inculcate this spirit in all members of the society and stimulate their interest in their mission. It will appeal to them to set aside a part of their capital surplus for the needs of the community, in the name of Allah, to invest in the community's interest instead of investing in order to earn private profit. The Government's success in educating the people to this end is devoutly to be wished. Certainly in time of war the Government will be able to get interest-free loans from the public: if the fundamental Islamic spirit exists in the community and is properly awakened, the people will surely be prepared to sacrifice the profit on their surplus wealth in order to deal with the extraordinary crisis of the moment. The more the authorities in the Government hierarchy can demonstrate high ideals through their own example, the more successfully will they inspire the co-operation of the public at large.

Besides this general motive, some purely economic incentives can be adduced in favour of lending to the Government. In earlier discussions we have indicated that some people will, by temperament or from circumstances, refuse the risks involved in investing their money profitably and will prefer, instead, to keep it in the banks' loan accounts. There are many who, while disinclined to invest, will leave their savings for long periods in the loan accounts, on the assumption that this money is safe and that, though it neither increases nor decreases, they can withdraw their money when they wish. For such-minded people, we believe, it may be preferable to loan their money to the State than to deposit it in bank loan accounts. Firstly because the higher prestige of the Government, as compared with the commercial banks, will persuade them that the Government's promises are more reliable and repayment of loans by the Government after the stipulated period more certain. Secondly, those people who balk at the risk of investment will, if they make loans to the Government, have the consolation of a reward in the life to come, for without undue sacrifice (and with the security of their capital assured) they will have contributed to the national cause. The Government for its part will be able to get large amounts of capital from such

depositors by obtaining short-term loans of different amounts – the precise form of the various provisions will be discussed later.

To achieve an increase in loans to the Government, some further incentive may also be necessary. We suggest that tax concessions may be the answer. If the people advancing loans to the Government have to pay less tax than if they either deposit their savings in the long-term loan accounts of banks or make some different arrangement for the security of their money, they will prefer to lend to the Government. As a considerable number of savers deposit their money only to keep it safe, rather than risk it by investment, a huge amount of money may be procured by the Government in loans. Moreover, a tax concession will encourage even those who, while prepared to sacrifice their own interest, would otherwise prefer to invest their money profitably: with tax concessions the sacrifice demanded of them will be smaller and they may be inclined to spare some part at least of their investable money for loans to the Government. Similarly tax concessions may encourage people to curtail their spending.

Even in modern times states use tax concessions or even exemption to stimulate certain activities: charitable institutions and charitable donations whether by individuals or by institutions as well as bodies seeking to further religious knowledge, are tax exempted. Similarly if an individual saves a portion of his income for his provident fund, the saving is tax-exempted by the Government in order to encourage the people to save for their future. Loans advanced to the Government for defence or for development purposes might be exempted in the same way to encourage an attitude among wealth-owners that favours the national interest, even prefers it to depositing wealth in banks in order to increase private wealth.

The detail of what kind and degree of concession or exemption will produce the desired results would require a separate study on its own and will not be attempted here, but general principles can be clarified. People willing to advance loans to the Government will either begin and then continue to save for a year (the term of the loan) or they will direct past savings (hitherto deposited in banks or invested in some profitable way). In the first case, the tax concession will be made in the individual's income; in the second

case a reduction will be made in the taxes normally levied on capital. If no capital tax exists or the existing tax system does not permit any suitable method of reduction some other steps will have to be devised – for instance, some concession might be allowed proportionately, in the income tax payable on the amount of capital provided on loan. When granting concessions every care should be taken to ensure that the different groups of people advancing loans, small savers and big capitalists alike, are treated with justice. The expected decrease in Government revenue from taxes must, of course, be less than the expected gain through receipt of the loans.

It must be made manifestly clear that tax concessions or exemptions have no taint, no semblance of interest. Indeed there can be, and should be, no confusion on this point. Interest is a fixed percentage of money paid out each year to the lender. Tax concession or exemption does not constitute payment to the person who gives the loan. Moreover the concession made in taxes will have its effect only during the year the loan is advanced, while no suggestion has been made that there be a further concession for every year that the loan capital remains in the Government's keeping.

Income tax and capital tax are based upon the amounts of income and the amount of capital – that is, on the individual's ability to pay. That ability is diminished when the individual advances interest-free loans to the Government. Tax concessions are an acknowledgement that the disability needs to be mitigated. In no sense do tax concessions, like interest, bring positive financial benefit to those who advance loans. It should be remembered also that the only beneficiaries of tax concessions will be those who pay tax, those whose income is high enough to make loans relatively easily. People with smaller incomes may also advance loans to the Government, but will not benefit by the above concession. By contrast, interest is payable to anyone who lends irrespective of whether his income is small or large. The same principle applies to capital tax: any concession will benefit only those who own capital above a certain limit and not every individual who advances loans in the national interest.

The capital procured by the Government will serve the

important interests of the whole society. Taxes are also collected for this purpose. Tax concessions aimed at an increase in the supply of loans may, therefore, be regarded, from the standpoint of the main social objectives of the Islamic State, as only an adjustment in methods.

The Loan Certificate

To acknowledge loans the Government should establish loan certificates, issued to the people advancing loans and constituting a proof and a receipt on behalf of the Government for the amount received from the person (or persons) named on the document. A copy of the document may be preserved in the Government records. Also, besides the date of the repayment of the loan to be clearly stated on each certificate, the name of the agent or institution through which the loan is repayable must also be indicated. The Government might use Post Offices, the State Bank, selected commercial banks and local branches of the Treasury for the issue and encashment of certificates. The system of depositing loan capital, the issue of loan certificates against them and repayment of these loans at a fixed time, should be run in such a way that the public have every facility without having to bear any of the expenses of the service.

Different types of certificates should be issued according to the amount and period of the loans. The amount, for instance, may be fixed from Rs.100 up to Rs.10 million and periods may be fixed from a fortnight, a month, three months and then upwards to three years. Certificates for all amounts and for all periods should be made available. If necessary or desirable certificates for less than Rs.100 may also be issued. In principle, there is no harm if some loan is made on the promise of repayment on demand (rather than at the end of the term) and the fact should be recorded on the certificate. However, if the Government does issue such certificates, it will affect capital deposited in the loan accounts of the banks. As considerable public interest is connected with these accounts, therefore, we would suggest that the Government does not accept loans repayable on demand. The short-term loan certificates should be issued in a number sufficient to meet the

borrowing needs of the Government at a particular time.

The loan certificates should be issued and may be 'sold' by the Government only.[1] The general public and the institutions may not buy or sell or transfer these certificates among themselves. As interest is prohibited there will be no possibility of a bargain on the above certificates by transferring them at a lower price than as entered therein on the document. There can be no economic incentive for selling or purchasing these certificates without an increase or decrease in the prices entered on them and our insistence that any such transaction be prohibited is simply a preventive measure to ensure that the door for deals with interest is not left open.

In our opinion there is no harm in offering loan certificates as security against loans from banks or individuals. As securities will normally have to be presented in order to get loans from the banks for business purposes or other expenses, people will be greatly benefitted by the availability of certificates for this use. The banks should require that the certificates produced as security are repayable before the date of repayment of the loans demanded, or at least, very soon afterwards. They should also obtain a written understanding from the borrower that if he fails to repay the loan at the fixed time, the bank will be empowered to present the certificate to the Government for the withdrawal of the capital entered on it and recover its own loan from that capital. As we have also proposed the issue of loan certificates of very small denominations, it will always be possible for individuals and business institutions, entitled to draw an interest-free loan from the banks, to present such certificates as security as are nearing maturity.

In a developed economy loans for the Government are a permanent necessity. The practical method of meeting this necessity is for the Government to issue new certificates every week and every year and to arrange their sale in such a number as

[1]The words purchase and sale are used purely for convenience. The advancement of loan is synonymous to the purchasing of a certificate for it but is not the purchase of the paper on which the certificate is printed. If the certificate is lost, the owner can get back his capital by producing a copy from the entries in the government records.

will answer its loan needs. If at any time the supply of loans is less than is required, the steps to be taken are, as already indicated above, a moral appeal and additional remission in payment of taxes.

In the last chapter we have explained that the Central Bank will advance loans to the commercial banks against the loans advanced by them. We have called the ratio between these loans the borrowing ratio. It follows from this that, if the commercial banks have purchased some loan certificates, i.e. they have advanced loans to the Government, they may present these certificates for drawing loans from the Central Bank according to their borrowing ratio. If needed, the borrowing ratio for Government loan certificates can be higher than the borrowing ratio relating to loans given to the private sector.

This will not lead to a shortage in the supply of loans to the private sector as the banks have a vested interest in lending to their clients. As already pointed out, short-term loans given to entrepreneurs operating with *muḍāraba* capital obtained from the bank, will contribute to the higher profitability of their enterprise. The Central Bank can readily manipulate the borrowing ratios applicable to loans supplied to public and private sectors with a view to ensuring adequate supplies to both. Priority should, however, be given to the private sector and only the surplus lending capacity of the commercial banks should be channelled into the public sector.

In this study we need not discuss in detail how the Government will arrange repayment of the loan money. It can make use of the benefits of its development schemes, the profits from businesses running with loan capital, tax revenue, and it can procure new loans. In the short run, when full productivity is not yet feasible in the industries in the public sector and some of the development schemes are still in their primary stages, new loans may have to be made the major means of repayment, besides additional taxes. The Government will have to make arrangements for loans of larger amounts of capital than the amounts repayable during any week or year. After the restoration of normal conditions and an increase in Government revenue due to development, a completely different method may be adopted and the total burden of

public debt may be lightened by keeping the amount of new loans lower than the loans repaid.

If at some time the needs of the Government are not met by the loans provided by the people or in spite of all efforts the amount of loans repayable exceeds the incoming amounts from new loans, it will resort to deficit financing. The practical procedure will be the sale of loan certificates to the Central Bank which will be required to create new money against these certificates. This new capital will be created through production of new currency notes or in the form of fresh entries in the Government's account in the Central Bank. The Central Bank can be made a means of tidying up temporary loan requirements necessary because of variations in the rate of income and expenditure of the treasury. The Government may, for this purpose, sell loan certificates for a week or (at most) three months to the Central Bank, which will arrange their sale to the general public. Should any of these certificates not be bought, the Central Bank will meet the deficiency by creating new money.

When the Government wants to spend less than its income (to use, in place of deficit budgeting, surplus budgeting) it may withdraw the loan certificates from the Central Bank and pay for them in cash. This change in the Government account will be in the form of an entry or will involve actual transfer of currency notes to the Central Bank. In either case, there will be a decrease in the supply of money in the economy.

If, in spite of all these measures, the loan needs of the Government cannot be fulfilled, it may seek to use small savings of the public, by establishing very short-term loan and saving accounts in the Post Offices. This method will be especially useful, because, in this way, it will be easier for people to save and accumulate their deposits. As people know the normal rules and regulations of savings banks, it is unnecessary to go into them here in detail. Although the Government will not pay any interest on these savings, it may provide the savers with some facilities that will attract savings into these accounts. Besides payment on demand and security, the Government can, like some modern states, offer to pay or transfer money from one account to another.

This procedure is known in modern times as the Giro system.[1]

In addition the Government may try to directly acquire the peoples' savings in loan and *muḍāraba* accounts by establishing a commercial bank with branches all over the country.

We have not dealt with foreign loans in this discussion because, as mentioned earlier, we are assuming herein a closed economy without links with foreign countries. Although this premise contradicts the actual case, yet it cannot be avoided in the interest of convenience in the preliminary stages. Many questions arise in relation to foreign trade and transactions involving capital investment, which can only be studied separately.

While discussing the nature of Government partnership and *muḍāraba* shares and loan certificates, we have elucidated only partially their relationship with the banking system. A detailed discussion of this aspect of the problem is essential. For the moment, we will outline, briefly, the general function of these shares and certificates in the interest-free banking system.

Government Loan Certificates in the Banking System

Since the ratio of loans which may be obtained from the Central Bank against loans advanced to the Government will be higher than the ratios for other loans, the commercial banks will keep a number of Government loan certificates in their custody in order to maintain their liquidity. They may do so by keeping loan certificates of various terms and when needed use these as an exchange for cash from the Central Bank. The commercial banks are unlikely to purchase long-term certificates. The total value of loan certificates purchased will be less at those times when the banks themselves need loans, than when the certificates, having completed their term, become payable. The banks will purchase new certificates by cashing in loan certificates which have completed their period, in the same or even a larger number. Normally, the portion out of the total amount loaned by a

[1] This method is in use in Germany and Sweden. In Switzerland also there is a similar system. If a Post Office account holder wants to transfer an amount to some other person, the Post Office complies with the order, whether that person's account is in the Post Office or in some other bank. See R. S. Sayers, ed., *Banking in Western Europe*, pp. 62, 262.

particular bank, intended for the purchase of Government loan certificates, will depend upon how highly that bank, at that time, regarded the importance of its liquidity in relation to its need to lend (in its own interest) to businesses directly or through commercial bills of exchange.

Different banks will formulate different policies at different times: their general principle will be a calculation of the demand for loans from businesses and the bank's needs for cash in the near future. At what level the borrowing ratio for Government loans and then the general borrowing ratio, should be fixed, can only be answered in the light of practical experience. As we pointed out above, while deciding the level, the Central Bank will not have as its only objective an increase in the banks' supply of loans to the Government, but will have to pay full attention to the business interest of the commercial banks, the loan needs of businesses and of consumers, and of the public in general.

Government loan certificates will be an important instrument of fiscal policy for the Government. As mentioned above the presence of these certificates will facilitate deficit and surplus budgeting. The Government may also achieve a decrease in effective demand by increasing the sale of these certificates or an increase by repayment of loans or by selling fewer certificates than are repaid.

Government Partnership Shares in the Banking System

As we pointed out in Chapter 5, the banks should purchase partnership shares as a secondary reserve besides their cash reserve. Such shares carry very little risk of loss and can be sold at any time for cash. Indeed, if (as we believe) the risk of loss is purely theoretical, any uncertainty will relate only to the rate of profit that may be expected after a certain period, it follows that partnership shares with the Government will be a source of income for the bank as well as a means of maintaining liquidity. If there is no risk of loss the share price will not fall below its nominal value and will on the contrary rise within reasonable limits. When banks need cash they will sell the shares on the market in the hope of profit, or (at worst) at minimal loss. On shares they do not sell

the banks will, of course, receive profit; they may use this profit to buy more shares from the Government or, if they wish, in some other way. But by puchasing partnership shares in large numbers the banks will be able to take an effective part in the running of the public sector enterprises, and therefore will be better able to protect and enhance their own interests in these enterprises. This should be an important incentive to banks, and the Government may expect to receive a large investment of capital from the banks through the sale of partnership shares.

If needed, the Central Bank might make it compulsory under the regulations for all banks to use a fixed percentage of their loan and *muḍāraba* accounts to buy Government partnership shares, and thereby maintain the liquidity of the entire banking system as well as protect the interests of account holders. But in our opinion this should not be done at the very beginning of the experiment in interest-free banking. The banks should instead be left to themselves in this regard. If the Government can raise the prestige and value of partnership shares by demonstrating the success and efficiency of the public sector enterprises and their share price is stable on the market, it is likely (and extremely desirable) that banks should start to use those shares as a secondary reserve. It would be best if the level of secondary reserve is settled as a result of independent decisions of the banks in the light of their own experience and conventions.

As explained in the last chapter, the Central Bank will make the sale and purchase of Government shares a means of increasing or decreasing the supply of money, and by maintaining the rate of purchase of these shares above the rate of sale, it will be able to sustain a continuous increase in the supply of cash in the economy.

Government *Muḍāraba* Shares in the Banking System

As these shares will not be saleable on the market, their function will be very much limited in the banking system. When the Central Bank wants to keep some shares in its custody until maturity it will purchase *muḍāraba* shares. There will not be much to attract the general banks to *muḍāraba* shares, especially as the only advantage of Government *muḍāraba* shares over

ordinary *muḍāraba* shares will be that there is virtually no risk of loss in investing in the former. There is little benefit in *muḍāraba* shares from the viewpoint of the bank's liquidity; nevertheless if it is evident from practical experience that a reasonable rate of profit can be earned from Government *muḍāraba* shares, the banks may invest some part of their business capital in this way. Like other secondary assets the *muḍāraba* shares could be produced as surety by an individual or by institutions taking loans, provided that the term of these shares finishes near the date of repayment of the loans. *Muḍāraba* shares will serve as a suitable alternative especially for the small saver to depositing capital in the banks' *muḍāraba* account.

The presence of the above mentioned shares and certificates in a large number will be a means of convenience and orderliness in the nation's monetary system. Such shares will be convenient also as security against loans and credit, as well as being a profitable use of savings. They will help the banks as part of their secondary reserve, as a safe, profitable use of capital, and as a means of getting loans from the Central Bank. The Central Bank for its part will use these shares and certificates as a means of passing its decisions on to the commercial banks. Finally, the Government will use them in the implementation of its monetary policy.

CHAPTER 8

Loans for Consumers

The outline of banking in an interest-free economy presented in the preceding chapter sheds no light on the procedure for advancing loans to consumers because such loans are of a special nature. To explain the supply of loans to the Government, it was necessary to deal with public finances in general. Similarly unless we discuss in the most general way how in an Islamic society, the demands of needy people are to be met, we cannot rightly explain, even summarily, how interest-free loans should be made available to satisfy the needy. Looked at in this way, both the problems seem to be interlinked which means a detailed discussion of the social security system before we can deal with the supply of loans to the needy in particular. In the following we shall attempt to answer the question of supply of loans to consumers (i.e. those not borrowing for purposes of business) while avoiding, so far as possible, those larger, general problems.

The Needs of Consumers

The members of society who need 'consumer' loans may be divided into two general categories.

To the first category belong those who have neither assets nor source of income with which they might repay a loan. In fact such people do not need loans but financial assistance. In an Islamic State provision should be made to help such people, but banks could only advance loans to consumers from whom repayment may be guaranteed.

To the second category belong those who have assets and a source of income, and if they get loans temporarily to meet their existing needs, can repay them from their future income.

Needs can be distinguished into primary and secondary needs. Primary basic needs are those upon the fulfilment of which depend the existence and continuance of human life, needs such as food, clothes, medical facilities, housing and education.

Without fulfilment of the primary needs, a proper human standard of life is scarcely imaginable. But there are the secondary basic needs also, also pressing, whose fulfilment is essential for a contented and happy life: for if the individual cannot develop his full potential, he cannot take a responsible active role within his community, and society as a whole is the poorer. Indeed, if human potential is frustrated or wasted, the individual may suffer mental and emotional deprivation, he may develop a negative attitude to life and to the community, and again society as a whole is the poorer. The welfare of individuals and communities demands therefore that the basic needs of the society's members are satisfactorily met according to a proper standard. There are appliances which make life easier and more comfortable and save time and physical labour such as a comfortable house, furniture, electrical equipment, fans, washing machines, refrigerators, sewing machines, automobiles and so on. There are many other kinds of such needs that may be mentioned, for instance the desire to give higher education to one's children, to give articles of use in daily life to one's daughters at the time of their marriage, and so on. The need here is to make life easier, more comfortable, more useful, and the articles that serve these needs are called by economists, articles of comfort. The renowned Islamic thinker Shātibī calls them *'Ḥājiyāt'* (secondary needs): he considers them second after the primary basic needs and pleads that the fulfilment of these needs according to their feasibility, be included in the objectives of Islamic *Sharī'a*.[1]

It is always the natural instinct of the individual that he will wish to meet all his needs out of his own labour and income, but, as we said above, the Islamic community (ultimately the Islamic State) is reponsible for making necessary provisions to meet the basic needs of those individuals who, from infirmity or unfavourable circumstances, are, if unaided, unable to meet such needs.

[1]Abū Ishāq Al-Shātibī: *Al-muwāfaqāt Fī Uṣūl al-Sharī'a*, Vol. IV, p. 30, Maktabatul Tijāriyaal-Kubrā, Egypt. (The year of publication is not mentioned.)

Individuals who with their personal wealth or income meet the primary needs of their family also attend to the fulfilment of their secondary needs. Many people succeed in this endeavour and many do not. Muslim scholars have been realistic about this and not imposed any clear and fixed responsibility for provision of the deficiency on the Islamic State. But it appears to be the intention of the Islamic *Sharī'a* that both community and State should, as far as may be feasible within the existing economic resources of the country, work for and with every citizen. Well-provided, energetic citizens, conscious of making progress in life, of finding satisfaction in it, will in the end prove useful for the society as a whole and assist in the achievement of its general objectives.

Sources of Loans

We may now return to our original question, how to procure loans for individuals who have some assets and some source of income and temporarily need additional money to meet their needs. We believe that the responsibility for giving loans to individuals for the basic necessities of life, actually devolves on the *Bait al-Māl.* As far as possible, private individuals should also, through mutual co-operation, try to satisfy the need for such loans. Individual members of the society might establish autonomous self-help bodies, mutually co-operative, which raise funds by depositing small savings every month: loans could be provided from the funds to individual members as the need arose. Savings banks and insurance companies and other institutions based upon mutual co-operation, whose objective is not to earn profit, can fulfil this important social function.

The Islamic State should make up the loans that the co-operative ventures are not sufficient to support. It may for this purpose set up a separate fund and appeal to the charity of individuals *(Qarḍ-e-Ḥasan)* and alms money, likewise, a part of the *zakāt* and income from *'ushr* might contribute to the fund. From this fund loans may be advanced to the needy, after study of their circumstances and on production of proper securities, for a suitable length of time.

Some scholars are also of the opinion that factory owners and

employers might be made responsible for advancing loans to employees as needed, and recover them by instalments from their salaries or wages. On a limited scale this method is already practiced in the contemporary economy. The employees might take loans from the money they have deposited in their Provident Fund, and in some institutions there are such facilities. This is a workable proposal, rules of which should be formulated bearing in mind some protection for the interests of the factory owners as well as their employees. The great advantage of this proposal is that recovery of loans thus advanced is relatively easy.

There is no reason in principle why loans of this sort should be restricted for use in meeting primary needs, and in our view, they could be extended to loans for even secondary needs.

There are some special points regarding secondary needs that deserve note, that is, needs such as the construction or purchase of a house, and fixtures, and durable goods such as furniture, electrical appliances, cars and the like.

A house is in some sense a primary as well as a secondary need. It requires such a large amount of money that loans to meet the need of a house will have to come from a variety of sources. Some responsibility, must, however, be borne by the State. The State should establish a special department for supply of loans needed for the construction or purchase of houses, and this institution should be run as a section in the Department of Public Welfare – providing loans to those in need after proper consideration of their needs and of their capacity to repay the loan. Proper rules and regulations should be framed for the repayment of these loans, and the house for whose construction the loan has been advanced should serve as security. Besides the State institution, loans from co-operative organisations, employers, factory owners and banks can also be utilised for this purpose.

The State should also take part in the supply of loans to purchasers of durable consumer goods – but this will be more appropriately dealt with when we have duly considered the role of the Central Bank in the supply of consumer loans.

Bank Loans for Consumers

Banks are actually business institutions, whose objective is to earn profit. To what extent the responsibility for supplying interest-free loans can be placed on them has already been discussed in detail in Chapter 4. Business institutions deserve priority in the advance of loans from banks and only a limited responsibility for advancing loans to the consumer can be borne by banks.

Right of Overdraft

The first form is that the depositor be entitled to overdraw the amount deposited by him and this overdraft may be permitted for a fixed period and if the bank deems it necessary it may also demand security for the overdraft.

In general, the banks will not experience any difficulty in giving loans of small amounts to trustworthy account holders. But a limit should be fixed for the advancement of such loans to an account holder, bearing in mind the average of the money deposited by him, monthly or weekly, in his account.

Under what circumstances a bank would agree to advance such loans should include the fact that the purpose of the loan is to meet essential needs, primary or secondary.

Although these loans should be advanced to meet secondary needs, yet if an account holder intends to buy some durable goods, it should be possible for him, besides making use of other resources available to him, to utilise the method of overdraft. The banks should realise, however, in this connection that in respect of their current conditions and resources they are free to limit or extend the advancement of such loans. The policy of banks may vary. For instance, one bank may allow overdrafts for the purchase of motor cars, while another bank may not be willing to do so for this purpose.

The operation of an overdraft would persuade some members of the public to become account holders of the bank so that they might, if the need arose, have the advantage of withdrawing a higher amount than their own deposits. The overdraft would thus

bring about an increase in the bank's loan account which would in turn strengthen its business, and the bank would not feel much difficulty in giving loans to consumers on a limited scale.

The loans advanced by the banks to their consumers will be based on the proportion determined for the advancement of loans in general. Banks will be able to draw loans from the Central Bank under the general loans regulations against their 'consumer loans'. Thus banks can be fairly certain that the consumer loans advanced by them will be repaid: as the transaction will be with their own account holders, there is less likelihood of default. In the event of an account holder's bankruptcy, or extreme neediness, or death without leaving assets, etc., when repayment of a loan becomes impossible, the Islamic State will have to take the responsibility. It must, however, be determined before payment of any un-repaid loans that the bank has complied with necessary rules and regulations before advancing those loans and that their non-payment is not due to any irregularity or carelessness on the bank's part. The justification for this proposal is that placing the responsibility of interest-free loans on the banks demands that repayment is ultimately guaranteed, and this guarantee can only be given by the State – in its absence no advancement of loan is feasible on the principle of interest-free banking, as was explained in Chapter 4.

Putting the responsibility of repayment of bad debts as a last resort on the Islamic State is neither strange nor unreasonable. Among the various allocations of *zakāt* and *'ushr* there is one intended for assistance to borrowers unable to repay their loans. Indeed, in the days of the Prophet, upon him be peace, the responsibility for the loans of deceased debtors was discharged from the *Bait al-Māl,* as is evident from the following *hadīth:*

> 'I am closer to the believers than themselves, so if one of the believers dies in debt, I will repay it but if he leaves wealth, it will be for his heirs.'[1]

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[1] al-Bukhārī, Ṣaḥīḥ, *Kitābul Nafaqāt, Bāb Qaulun Nabī Sallallāhu 'Alaihe wa-Sallam: Man Taraka kallan aw ḍiyā'an fa-ilayya.* The same *ḥadīth* is quoted in Muslim, Tirmidhī and Nasā'ī with some difference in the text. Abū 'Ubaid has quoted this proposition in *Kitāb al-Amwāl* in nearly the same words. For further details see Siddiqi, M.N.: *Islām Kā Nazariya Milkiyat*, Vol. II, Chapter II.

No doubt the statement of the Holy Prophet is in his capacity as Head of the State, and not as an individual. Moreover, under the well-known rule of the bank, all accounts whose owners have died without heir, or whose heirs are untraced for a long period of time, are ultimately transferred to *Bait al-Māl*. Such accounts might also be used (perhaps more directly) against bad debts.

Certificates of Sale

Another way of lending to consumers who want to buy durable articles (like motor cars, etc.) on instalments is that the buyer should give a certificate to the seller and the bank may adopt the procedure for encashment as with bills of exchange. The certificate of sale will contain a detailed description of the article, its total cost, procedure of repayment, and name and address of the sellers and buyers. The certificate will be kept by the seller and he will encash it from the bank, i.e. draw the full amount entered in the certificate. It is the responsibility of the seller to secure payment of the instalments until the account is cleared. The articles purchased on credit in this way will be kept under close watch as security until the full cost has been repaid. In case of default, the seller will be authorised to sue in a court of law and confiscate the articles concerned to recover their cost. The difference between this method and loans from the bank is that the latter can only benefit those who have bank accounts. The Government will have to regulate the system of sale on credit. As the major source of credit for consumers, entrepreneurs and the Government are the demand deposits, their relative shares out of this pool will depend on a number of factors. First, the borrowing ratios fixed by the Central Bank for giving cash to the commercial banks against the loans supplied by them to the various groups – consumers, entrepreneurs, Government – may be different. These ratios can be changed from time to time to ensure equitable distribution of interest-free credit.

Secondly, the banks caring for profit as well as liquidity are expected to adopt a realistic and helpful approach to providing interest-free loans. If needed the Central Bank can fix quotas for various categories. In our opinion the present vast expansion in

consumer credit is not very desirable. There is no place here to examine in detail the evils of the instalment purchase system so prevalent in some advanced countries, notably the U.S.A.

The way this method has imposed the evil of interest upon all members of society and through interest, transferred a sizeable part of the income of the poorer class to the richer class is unparalleled in history. In spite of State supervision and strict regulations purchasers have to pay a heavy rate of interest.[1] Very frequently a considerable amount of money has to be paid for service charges.

Thus a considerable part of the income of an ordinary consumer who agrees to buy a house, furniture, motor car and other requisites on instalments goes to the payment of interest and service charges, and in order to have the goods sooner he accepts the responsibility of paying $100 for goods worth $75.

Another defect of this system is that it induces one to spend extravagantly and beyond one's capacity. The unrestrained advertising prevalent in the U.S.A. and other advanced countries also plays a part in spreading this evil. By making use of various psychological methods, it creates a craving among consumers for the use of many showy and unnecessary articles. Then the buyer is persuaded by having available extraordinary facilities for paying, on instalments, to buy what if he had to pay cash he would not buy. Consumers who in the formative years of their life indulge in such purchases remain encumbered by the instalments for a long time, while, of course, needs arise which have to be met even though such a large part of their income is devoted to keeping up due instalments. In consequence, such consumers are perpetually preoccupied in devising ways and means of increasing their

[1]'An interest rate of 2 to 3% per month (24 to 36% per year) on unpaid balance is now common . . . There are still loan sharks operating and charging fantastic rates. Rates of 20 to 40% per month are common.' Paul M. Horvitz: *Monetary Policy and the Financial System;* Prentice-Hall, Inc., New York, 1963, p. 147.

Another writer says: 'On matters of rate of interest, the facts are almost unbelievable. Some ten to fifteen states in the past four or five years have passed legislation setting ceiling rates of interest that may be charged on instalment or revolving credit. The lowest rate allowed in many of the states as an acceptable interest charge is 20 per cent . . . For revolving credit the rates range from between 18 per cent to as high as 50 per cent, and 100 per cent if the account drops down to a minimum.' Arch W. Troelstrup: 'The Influence of Moral and Social Responsibility in Selling Consumer Credit.' *American Economic Review*, vol. LI, No. 2, May 1961, p. 553.

income or must ignore their present needs to pay the instalments on the scheduled dates: all this creates unhealthy attitudes in the lives of these individuals, strangulated by loans, and this affects very adversely their capacity to work constructively or to live happily.

From the standpoint of the society as a whole, the great disadvantage of the instalment system is the sheer waste of energy involved in accounting the instalments, collecting them, taking legal action against defaulters, recovering already sold goods. By contrast cash purchases are free from these vices. Undoubtedly there are advantages in credit sale but its detrimental consequences and its true cost, seen in the wastage of human potentialities, are enormous. In the overall economy credit selling leads to a remarkable increase in demand, which generates expansion in industries. But, at the same time, it becomes increasingly possible that with a decline in the rate of increase of credit purchases, effective demand may be retarded, the economy may fall victim to decline in income and production and may start recession.

Yet, as we pointed out above, the facilities for purchase on credit have provided a number of advantages for consumers. The greatest advantage is that if at the very beginning of an individual's working life most of the articles for permanent use (e.g. house, transport, etc.) are made available, it increases his productivity. This increased efficiency may also raise his income and it may also benefit the whole society. Because most of the goods concerned are such that if an individual tries to save the necessary capital out of his income, it will take him a very long time, his efficiency will be severely affected if the needs for a house or for transport are not met. It is true that, in the end, he would be able to buy these things and be, in later life, free from the encumbrance of credit – nevertheless, in most cases it is better that such goods are in use and paid for in the future. The chief argument for this preference is the increase in efficiency, and satisfaction in life, which in many cases is associated with the possession of such goods.

The main objective clearly is to find some means free from excesses and deficiencies, which can be done after practical

experience. We are of the opinion, however, that the procedure regarding credit sales suggested above is of limited scope. It is, therefore, advisable and necessary to adopt other methods also. In the light of the comments above, it is right that the Islamic State should assist consumers with some needs – in the purchase of articles of permanent use. Assistance may be in the form of cash loans specifically for purchasing houses and means of transport, but another form may be that the State itself arranges the sale of such goods and consumers pay their cost in easy instalments. We propose that both methods be adopted and that the procedure for repayment of loans or of the cost of the goods be designed for the convenience of both parties. For instance, there should be an agreement with wage-earners that the instalments will be recovered directly from their wages and transferred to the department concerned. Other suitable procedures may be devised for purchasers who draw their income in different ways.

A third way to assist consumer purchases would be for the State to accept responsibility for encashment of sale certificates for certain specified goods. The State could pass to the Central Bank or other suitable institutions the task of accepting certificates of sale and buying from the sellers in cash and on the dates due recovering the instalments. If only to widen the number of options this method should also be accepted.

Some general points should be borne in mind for the Islamic State's active role in providing articles of permanent use to consumers.

Firstly, it will be more convenient for the State to recover instalments than for private institutions: the State will be able to obtain the cooperation of factory owners and employers generally in recovering instalments directly from pay. Moreover, a large number of purchasers will be employees of the Government and its departments from whom it will be still easier to recover instalments.

Secondly, the capital required for consumer articles may be got, in part, out of the money allowed in the general budget for social welfare services.

This capital will also be increased by the profit from the business; a considerable number of purchasers on credit may be

those who, being ineligible to pay *zakāt* are entitled to receive it. Deposits in *zakāt* and *'ushr* accounts may be used to advance loans or to obtain on credit articles of permanent use for people in need. These facilities are not available to private entrepreneurs and can only be made use of by the State.

As the provision to consumers of articles of permanent use is a social service as well as being a business, the State should undertake the responsibility. Possession and use of such articles improves the efficiency of individuals in the society, and failure in this regard will nullify an important objective in the interest of all, a well as frustrating the hopes and aspirations of needy individuals. Entrepreneurs in the private sector will not be able in an interest-free economy to satisfy these aspirations.

Banks may well be given some of the responsibility. But it is imperative that, alongside the banks and self-help cooperatives, the Islamic State take an active role. It may be motivated to do so for reasons besides those we have discussed explicitly. To prevent extravagance the State should regulate the system of purchases so that consumers stick to principles of moderation while taking advantage of payment by instalments. Ultimately when most consumers have to apply to the Government, its rules and regulations can be easily enforced. Provision of credit-purchase facilities to an individual applicant should be made with respect to his needs and his capacity to eventually pay: his general circumstances should be properly studied. Some restriction should be determined to limit credit facilities. It goes without saying that the Government's rules and regulations must be adhered to also by private institutions and banks.

CHAPTER 9

Some Clarifications

In the preceding chapters, we have proposed a new system of banking on the Islamic principles of partnership and *muḍāraba* which may be run without charging interest and yet discharge all those functions which are carried out by the present banking system in our existing economy. As there has been no practical experiment with interest-free banking, there will be some reservations, suspicions and apprehensions about it which deserve consideration. We shall in this chapter deal with some of these, as follows:

1 Supply of savings.
2 Supply of capital to entrepreneurs.
3 Procurement of capital for the public sector.
4 Prospects of profit in the banking business.
5 Liquidity of the bank.
6 Interest-free banking and the State.

1 Supply of Savings

We have already discussed the question of depositing capital in the loan accounts of interest-free banks and the conversion of most of it to loans for entrepreneurs, and investment on *muḍāraba*.

In the loan account the supply of capital is not dependent so much on saving as on the general practice that people deposit the larger part of their income in current accounts, and use their money by issuing cheques. We may, therefore, turn to deposits in the banks' *muḍāraba* account. As, in this account, deposits are made for longer periods (three months, six months or more) and withdrawals through cheques are not possible, only surplus capital

or savings will be deposited. The supply of capital to the *muḍāraba* account is then entirely dependent upon the propensity of people to save. It is very doubtful, in our view, that the prohibition of interest will weaken this propensity.

The inclination to save is affected by some intrinsic and some extrinsic factors, among which interest or its rates do not have any significant place. Modern economists are also in agreement with this principle. J. M. Keynes lists eight motives in his discussion of the intrinsic factors – saving for emergencies and accidents, saving for the future, for example for old age, saving for the education of one's children, for a sustained or gradual rise in standard of living, for a sense of power and independence, saving for business transaction or speculation, saving for one's heirs, saving out of miserliness, or finally 'To enjoy interest and appreciation, i.e. because a larger real consumption at a later date is preferred to a smaller immediate consumption'.[1]

The prohibition of interest will not influence the first seven motives. The desire to provide for the future or to leave something behind for one's dependents, or to accumulate capital for business purposes, will be as strong in an interest-free system as in the present economy based on interest.

Saving a part of income with a view to earning profit from it is an important factor. The real incentive is not interest as such but some increase in income. Such an increase may be secured in an interest-based economy by making time deposits or saving deposits with banks. In an interest-free system this method of earning profit is out of the question, but there are alternative methods of doing so. If these alternatives can be relied on for earning an increase on the deposits there is no reason why the relevant motive for saving should be weakened or die out. However, before assessing the uses of savings capital (through the banks' *muḍāraba* accounts, through *muḍāraba* shares in private or public sector enterprises), it will be worthwhile clarifying a little further the fact that, in existing economies, interest has not been considered a strong motive for saving. It has not been thought

[1]J. M. Keynes: *The General Theory of Employment, Interest and Money*. London: Macmillan, 1957, p. 107.

significant either as an independent factor or in conjunction with other factors. Also, most economists accept than an increase in the interest rate does not achieve an increase in the supply of savings. What difference it does make is negligible.

Keynes has emphasised the decisive importance of income-level besides that of social conditions, political organisation and stability, etc.

Following Keynes, further investigations have brought several important factors to light: the wealth of an individual or the extent to which his properties can be readily converted into cash; the relative prices of consumer goods; the distribution of wealth in the society; the availability of loans to consumers; an upward trend in the standard of living of the individual, his economic standing and the speed with which it may improve. Alongside these factors, the moral values of the society, the rationality of its members, and other non-economic causes and factors also influence the propensity to save. Some years back in the U.S.A. a Commission which was appointed to study money and credit,[1] expressed the following opinion in their report: '. . . although considerable emphasis on the direct and indirect roles of the interest rate as a determinant of consumer expenditure is found in both classical and Keynesian theory, the preponderance of evidence is that, its influence, if any, is negligible in comparison to other factors . . .'[2]

In Britain the Radcliffe Committee appointed to study the monetary system also stated in their report that most economists and specialists are of the view that an increase in interest rate does not bring any rise in the individual's saving.[3] In fact the inclination to save is mostly determined by other causes and factors. The desire to increase wealth simply by accumulating capital is only a secondary motive.

To return to our real problem: in the interest-free banking system it would be obligatory, in the hope of profit, to undertake some risk of loss by depositing savings in the *muḍāraba* account or by purchasing *muḍāraba* shares. In either case, the expectation

[1]Commission on Money and Credit (CMC) *Impacts of Monetary Policy*. Prentice-Hall, Inc., 1964, pp. 13–21.
[2]*Ibid.*, p. 41.
[3]Radcliffe Committee Report: Her Majesty's Stationery Office, London, 1959.

of profit is accompanied by the risk of loss and under no circumstances is there any guarantee for the refund of capital with any fixed increase. The question now arises if, in the absence of a guaranteed method of additional earning, saving for the sake of profit will stop, or if (even with the risks involved) the incentive to save will survive.

In fact, the fear of loss is not, by nature, so strong as to permanently overwhelm the hope of profit. The history of mankind witnesses that the hope of profit is a stronger factor than the fear of loss. Had it been otherwise, capital would not have been invested in as many risky enterprises as it was. Amongst those people who have capital surplus to their requirement the majority are willing to risk loss in the hope of profit. In spite of the safe alternative of interest many savers and investors in interest-based economies are drawn by the hope of a higher profit than the market rate. It would appear, then, that the fear of loss definitely deters some security-loving individuals, but it cannot deter all savers. Therefore, the most that can be said is that, in the absence of a safe alternative like interest, only some savers will be affected, only some will be deterred from saving – some, and not all.

We think the majority will continue to save, and for a special reason. The availability of a method of risk-free profit, namely interest, tempts savers from a more enterprising use of their capital. If interest is no longer permitted and the procedure of investing in *muḍāraba* accounts initiated in its place, the majority of savers will switch to this method. The apprehension that, in the absence of secure interest saving will decrease or stop, is neither based upon clear thinking nor upon empirical evidence.

In all events, if the system runs properly, depositors in the *muḍāraba* account and purchasers of Government shares will seldom suffer a loss. In most cases it will be possible for the majority of banks and for the Government not only to protect the savers' capital, but actually to increase it by sharing the profit made from it.

We have discussed in the previous chapters, the means of preventing loss to *muḍāraba* account holders. It hardly needs saying that it would be in the banks' interest also to prevent any loss – by screening business parties and projects carefully and by

spreading the capital investment intelligently, they should be able to guard against loss while aiming at profit. The same is true of the Government in its administration of *muḍāraba* capital.

These three points, taken together, that hope of profit is stronger than the fear of loss; that a means of earning profit without risk of loss has been prohibited; that alternative means of using capital without undue fears of loss have been made available; convince us that, in an interest-free economy, people who care for profit will still save. Given that the other incentives for saving which are, as we have seen, more important, will be unaffected, we may conclude that any decrease in the supply of savings due to prohibition of interest, will be negligible.

If at any time it is felt in an economy based on Islamic principles, that saving is on the decline and needs to be encouraged to bring capital formation up to a desirable level, appropriate action should be taken. For example, extravagance should be discouraged – prohibition of the extremes of conspicuous consumption will result in an increase in saving.[1] Moral appeals can also be expected to achieve significant results. In addition, in the interest-free system a suitable increase in the ratios of profit-sharing should also bring about an increase in the supply of savings. By the ratios of profit-sharing we mean that percentage share of profit received by banks from the business parties or by *muḍāraba* account holders from banks. In times of high demand for capital, entrepreneurs will offer the banks a greater share of their profit: the bank can then increase the profits paid to its account holders, thus inducing them to deposit more capital and increase their savings. If the supply of savings is high and demand for capital low, banks can reduce the profit share they would expect from the business parties. In doing so they will have to reduce the profit they share out to *muḍāraba* account holders, which in turn will reduce the supply of savings. Thus, in the interest-free banking system, suitable changes in the ratios of profit-sharing will balance the supply and demand of savings. This function is attributed to changes in the rate of interest in contemporary, interest-based economies.

[1]For the details see *Islām Kā Nazariya Milkiyat,* Part I, pp. 214-230, Part II, Ch. 12.

2 Supply of Business Capital

Of course, the savings of the ordinary man, transferred to entrepreneurs through banks or other means, constitute business capital. But we should not forget that a major part of business capital is provided by the business class itself. The greatest part of profit from business is reinvested and in most big institutions the greatest source of their capital investment comes from their own savings. This part of the total supply of business capital is not influenced by the rate of interest.

The depreciation allowance made by businesses against wear and tear (of machinery for example) is also used for capital investment.[1] In the United States, three-quarters of the capital of business institutions comes from internal resources.[2] The same situation exists in England. Again in the Redcliffe Committee Report, it is said that for industrial expansion, the major source of capital investment is the part of business profits retained for this purpose and a still greater amount of capital is that reserved on account of capital depreciation allowance against wear and tear of business equipment.[3] The Report noted that, after World War II, many businesses had met their total monthly requirements or the major part of it from internal resources. It further observed: '. . . retained earnings have been the most important source of capital for industrial expansion. Another important source has been the new issues market. Bank finance, on the other hand, has played a subordinate part'.[4]

In the United States, 70% of the total profit is saved whereas from individual income the percentage of saving is only 5%. In other countries also the situation is not very different.[5] Companies saving their profit do not intend to invest that saving on fixed rates of interest, but do so for investment in their own business. It is evident that prohibition of interest has no influence on such savings. The savings of business institutions are determined by

[1] Paul M. Horvitz: *Monetary Policy and the Financial System*, Prentice-Hall, Inc., 1963, p. 115.
[2] CMC *Impacts of Monetary Policy*, *op. cit.*, p. 655.
[3] Redcliffe Committee Report, p. 80.
[4] *Ibid.*, p. 108.
[5] N. Kaldor: *Capital Accumulation and Economic Growth in the Theory of Capital*, edited by D. C. Hagu, Macmillan, London, 1955, p. 197.

their own needs and factors such as the profitability of their business. The rate of interest has no significant influence on this.[1]

Thus we arrive at the conclusion that the prohibition of interest will have virtually no influence on the supply of business capital and if it does have any, it is too small to be of any significance.

3 Procurement of Capital for the Public Sector

The ways and means of attracting the savings of the people for capital investment in the public sector were described in Chapter 7. Here we would emphasise that, instead of interest, participation in profit be made the basis of attracting capital to the public sector. This may produce more useful results, especially when, to protect purchasers of Government shares from loss, some practical steps are taken. Participation in profit will give a large number of ordinary members of society a stake in the success of public sector enterprises and industries, and in their growth.

Many of those who purchase Government shares will in any case be Government employees in some capacity, whether as labourers or as administrators, whose livelihood will be linked to public sector success. A larger number still of those who purchase Government shares will be consumers of the products of Government industries. The realisation that the profit paid to them depends upon the profitability of the industries in the public sector will make them loyal. By contrast those who give loans to a Government on interest have no stake in the success of the industries in the public sector, because their own profit is already fixed and safe. It may be hoped, then, that as people's attitudes change, it will become easier for the Government to get their co-operation and make business in the public sector easier.

4 Profitability in the Banking Business

It is essential for the setting up and continuance of interest-free banking that the profit in banking business organised on the principle of *muḍāraba* – that is, obtaining capital from the people

[1] CMC *Impacts of Monetary Policy*, pp. 673-674.

on *muḍāraba* and then advancing it to entrepreneurs on the same principle – should be high. It has to be high in order to attract owners of large capital and the best commercial talent to the banking business. In the light of the detailed analysis presented in earlier chapters, there can be little doubt of the steady profitability of interest-free banking. It is important to remember that, while all capital in the banks' *muḍāraba* account will yield profit shares from its use in businesses, no responsibility devolves upon the bank in the (hopefully unlikely) event of loss.

5 Liquidity

Liquidity is vital for the bank for it must be able to give its account holders cash on demand without delay. We have clarified in previous chapters how the cash reserve and saleable certificates and shares will work to provide liquidity. But, as is argued by banking experts, liquidity is not based upon the bank's saleable assets or the length of time the bank might need to get back what it has loaned out, but upon its ability to get capital in the form of cash.[1] As the Central Bank is responsible for the creation of cash, there must be no problem for it to supply cash to the banks. There must then, it will be argued, be procedures for the banks to obtain cash from the Central Bank when they need it. Such procedures were explained in detail in Chapter 6: if these are carefully pondered, the conclusion must be that, so long as the bank uses wisdom and foresight in its choice of assets, it will have no problem in obtaining cash from the Central Bank when the need arises.

6 Interest-Free Banking and the State

Until recently banking was discussed and defined in the context of *laissez-faire* capitalism, but over the last 30 years the general trend of thinking of economics and banking experts has undergone a complete change. Now it is thought inevitable that the State must guide the banking system, and, through detailed rules and

[1]W. Manning Dacey: *The British Banking System*, London, 1958, p. 90.

regulations, run it on proper lines under a Central Bank. Besides the normal State supervision of banking proposed in this book, one should also keep in view the purposive nature of an Islamic State. One view on banking is that, as for other economic institutions, when the system fails to fulfil its function independently, the society, and the Islamic State should intervene and make necessary arrangements to realise the desired objectives.[1] These arrangements may include banking and public finances. Some aspects of this were dealt with in Chapters 7 and 8 of this book.

The proposed banking system is based on the assumption that individuals should be free to establish and run a bank, that banking would not be nationalised. If, however, at some time an Islamic State considered it in the larger public interest to do so, and the entire banking system was brought under State control, the proposed outline would not need any basic change. In Islam, the practice of paying and receiving interest is prohibited between individuals and the State as much as between one individual and another. The *Sharī'a* has neither made any discrimination in this regard, nor any exception, and in the whole extent of Islamic history, the Islamic State has never made interest-based transactions with its citizens.

Even in the event of nationalisation, banking business would be organised on the principle of *muḍāraba*. However, the banks' own capital would be provided by the State Exchequer instead of being obtained from shareholders on the basis of partnership, but the nature of the banks' relations with its account holders or business parties would remain exactly the same in principle, as explained in Chapters 2 and 4.

Now the question arises, whether it is justifiable or not to nationalise banks in an economy based on Islamic principles. This question can be answered only after a detailed study of the specific conditions in which such a step is being considered. However, it may be said here, in the abstract as a matter of principle, that it could never be justified in normal conditions. The nationalisation of banks would have far-reaching effects on the economic organisation and political system as well as on individual freedom

[1]For details of this point in principle, see *Islām Kā Nazariya Milkiyat*, Part I, pp. 73-83.

and it would endanger the balance between freedom and control – the balance which Islam aspires to maintain. But if some specific circumstances demand that, for the protection of the public interest and for fulfilment of the objectives of the *Sharī'a*, this step be taken, Islam has not imposed any restriction on doing so. This is not a question upon which the *Sharī'a* has a permanent injunction. It would also be wrong to rule out nationalisation on the basis of *ijtihād*. The decisive factor should be public interest. Nationalisation of banking would be perfectly in order when and if there was a consensus that the public interest in an Islamic society demanded it. Maybe such a need would be felt during the transition from a non-Islamic to an Islamic system.

APPENDIX

Literature on Interest-Free Banking up to 1967

A Urdu

1 Sayyid Abu'l 'Alā MAWDŪDĪ: *Sūd*, Islamic Publications Ltd., Lahore (1961), pp. 193-212,[1] 274-276.

In this book a brief outline of interest-free banking is presented. According to the writer, such banking will make three types of account available to the general public. Current accounts where the money deposited will be payable on demand, and which the bank may not invest. Loan accounts, where the money deposited will be payable after a fixed period, and which the bank may invest in profitable enterprises: the bank would be entitled to any profit and responsible for any loss – in either event depositors would receive back their deposits without any addition or deduction (pp. 205, 210). In the third type of account, the public deposit money for use on the basis of partnership (p. 210). These account holders will thus become shareholders in the banking business and shall share both profit and loss.

The bank will invest its capital in the agricultural, industrial and commercial enterprises on the principles of *muḍārava* or profit-sharing (pp. 210-212). The concept of *muḍāraba* is not clarified in detail, and on p.206 the meaning of *muḍāraba* as 'proportionate sharing in profit and loss' (given in parenthesis) creates misunderstanding, because on p.195, the meaning of *muḍāraba* is given as 'profit-sharing'.

However in the interest-free system, various ways of providing interest-free loans for personal needs are suggested (pp. 195-199)

[1] Some parts of this book were published in the monthly *Tarjumānul Qur'ān*, Lahore, Vol. 34, Nos. 2-5, July-Sept., 1950, p. 113-126.

and the question of providing loans to the Government and business is also considered (pp.192-202).

In this brief outline, the problem of credit creation through the banks is not discussed. About the workings of the Central Bank, it is said that its functions will be discharged by the State Bank.

2 Sayyid Abu'l 'Alā MAWDŪDĪ: *Rasā'il-o-Masā'il,* Part I, Islamic Publications Ltd., Lahore, 1961, (pp. 299-305). The author expresses the opinion that in the scheme of Islamic banking, it will not be appropriate, for various reasons, to include the functions of collection and distribution of *zakāt* and *ṣadaqāt.*

Rasā'il-o-Masā'il, Part VI, Islamic Publications Ltd., Lahore, 1967, pp. 151-173. The author believes that if the process of credit creation is not backed by interest and fraud, there will be nothing unlawful about it.

3 Naeem SIDDIQUI: 'Islāmī Uṣūl par Banking', paper in the monthly *Chirāgh-e-Rāh,* Karachi, Volume I, No. 11, 12, November and December, 1948, pp. 24-28 and 60-64.

In this preliminary sketch of interest-free banking, various aspects of the banking business are considered. The account holders' dealings with the bank would be more or less in accordance with the principles of *muḍāraba*, and the bank would entrust the money deposited to others in accordance with the same principles or invest it in its own business for profit (November, p.63). Here it is suggested that those account holders who deposit their money for longer periods should be offered higher profit to encourage long-term deposits.

With regard to loss, the statement that the principle of '*muḍāraba* makes the investor share the loss with the agent in the same way as he shares his profit' is misleading. In fact, according to the principle of *muḍāraba*, the investor bears the loss on his investment himself and the agent does not share it with him. Similarly, if the agent has also made an investment, in that event, he will bear the loss on his capital and the investor will not share it with him.

As regards the encashment of bills of trade, it is stated that the bank would be entitled to make payments in cash after deducting a commission, because this does not involve interest. The point deserves careful study.

4 Naeem SIDDIQUI: *'Ma'āshī Nāhamwāriōn Kā Ḥall,* Maktaba-e-Chirāgh-e-Rāh, Karachi, May, 1951, pp. 254-265. On p.147 the phrase 'The principle of *muḍāraba* means sharing in both profit and loss' indicates that the Islamic principles of *muḍāraba* have not been properly focussed and this has left its effects on the proposed sketch, mentioned above.

5 Sheikh Ahmad IRSHAD: *Bilā Sūd Bankārī,* Maktaba-Tehrik-e-Masāwāt, Drig Road, Karachi, 1964 (152pp.). In Chapters VI and VII (pp. 67-100), the system of commercial banking and in Chapter VIII, a structure for central banking are described. Chapter IX discusses problems of international banking (the author holds a degree from the University of Virginia, U.S.A.).

In the absence of a clear understanding of the Islamic principles of *muḍāraba* a basic flaw appears in the proposed system. On p.57 the principle of *muḍāraba* is described in these words: 'capital and labour both should be considered as shareholders in any enterprise, having equal shares in profit and loss'.

Banks should be established with the capital raised through shares, and the people would deposit their money in accounts from which it would be payable on demand. The bank would protect these deposits and, in addition, utilise the capital on its own responsibility, with the consent of the depositors for social welfare projects (p.69). The second type of deposits would be long term, and depositors would get their shares in the bank's profits on the last day of the year, proportionately to the size of their capital investment and the length of the period of investment (p.69). 'Islamic Bank could make its capital investment in a particular industrial enterprise in such a manner that in both the profit and loss, the bank as well as the enterprise shall be considered equal partners' (p.71). So far as the question of loss is concerned, it would be better for the Islamic Bank to maintain from the very beginning a Reserve Fund capable of meeting the liabilities of all the losses as is done by the banks even at the present moment (p.81). Depositors and investors of money should have the assurance that 'no recovery shall be made on account of loss from their deposits or capital investments' (p.81). 'The losses shall either be recovered from the above Reserve Fund or shall be

debited to those shareholders of the bank who had been responsible for all the transactions of the bank' (p.81). Moreover, on pp. 82-92 and 98, methods suggested regarding meeting the liability of losses are not in accordance with the provisions of the *Sharī'a,* hence they cannot be acceptable. In Chapter VII, the ways and means of granting loans to consumers and manufacturers are considered and interest-free institutions, like Industrial Development Bank and National Investment Corporation, are discussed. The Central Bank would remain in the hands of the Government and supervise the working of the whole banking system. It would make investments in businesses sponsored by its member banks (instead of advancing loans to them). The Central Bank would also share equally in the profits and losses of its member banks.

The Government would invite the public to provide capital for the implementation of its various projects and profit would be proportionately distributed among investors (p.108). The discussion is silent on the issue of the responsibility for losses.

However, in spite of the above-mentioned fundamental shortcomings, this book is a commendable attempt on the topic and some of its proposals deserve due deliberation. The author has established an interest-free institution in Karachi but, in spite of our best efforts, no details of its actual working could be obtained.

6 Muhammad AKRAM: 'Islāmī Ma'īshat men Bank aur Bachaten' (21pp.), paper in the monthly *Chirāgh-e-Rāh,* Karachi, Vol. XIX, November 5 and 6, May and June, 1965 (pp. 63-83).

This paper discusses savings in an Islamic interest-free system and considers the elasticity of the supply of savings relative to the factors responsible for determining the rate of profit-sharing. In addition some ideas are aired on the system of State Insurance and Social Security sponsored by the Government. The wrong notion about *muḍāraba*, that it implies sharing of both profit and loss, adversely affects the whole argument. I have discussed some of the points presented in this paper in my own article 'Islāmī Ma'īshat Ke Ba'ḍ Pahlū' in *Chirāgh-e-Rah,* October, 1965 (pp. 19-28).

B English

7 Dr. Anwar Iqbal QURESHI: *Islam and the Theory of Interest,* Sh. Mohammad Ashraf, Lahore, 1946.

On pp. 159-160 of this book the author presents his ideas on 'Place of Banking in an Islamic System' and suggests that like public health and education, the Government should sponsor banking as a social service in which the bank should neither pay any interest to account holders, nor charge any interest on loans advanced (p.157). Another alternative suggested by the author is that the banks should become partners with businessmen, sharing any loss that might be incurred (pp. 158-59). But in this connection no mention has been made of sharing of profit. Afterwards, quoting a Western author, a reform is suggested in the capital and credit system which simply means that taxes should be levied on savings so that people refrain from accumulating money and earning an income by lending it on interest, and that money should be used only as an instrument of exchange (p.161). The book has an introduction by Syed Sulaiman Nadwi which is clearer on Islamic banking. But the definition of *muḍāraba* is: 'One party should provide the capital and the other should provide labour, and both should have share in the profit as well as the loss according to a predetermined ratio'.

8 Sheikh Mahmud AHMAD: *Economics of Islam,* Sheikh Mohammad Ashraf, Lahore, 1952.

It is suggested in Chapter VII that the bank should be established by raising capital on a partnership basis from shareholders. No dividend or interest should be paid on the current account, but there should be another account in which the people may deposit capital on the basis of partnership, the bank's profit being divided in such a way that the shareholders receive more profits than the account holders (p. 156). The bank should provide capital to the businessmen on the basis of partnership (pp. 156-57). But the principle of partnership is not defined, nor is it made clear who, if the bank's business results in a loss, will be responsible for it. The author also recommends the establishment of the bank on the basis of a joint stock company in which the liability of the shareholders would be limited (p.156).

As regards the bills of trade, it is suggested that they be cashed without charging interest and for this purpose the capital in the Current Account may be utilised (p. 159). The Government may invite capital from the general public on the basis of participation in the profit for development projects (p.153) or may resort to deficit financing (p. 154).

9 Mohammad UZAIR: *An Outline of 'Interestless Banking'*, Raihan Publications, Karachi, 1955, 21pp.

The framework of interest-free banking based on the principle of *muḍāraba* presented here is in keeping with the *Sharī'a*. The question of central banking is not touched upon. Moreover, in dealing with the issue of expansion of credit, a very special argument is offered by the writer, namely, that no capital investment should be made with the bank's own deposits or with credits. This argument, being impracticable, deserves special scrutiny. However, there are useful discussions of international monetary relations (pp. 17-19).

10 Mohammad ABDULLAH AL-ARABI: 'Contemporary Banking Transactions and Islam's Views Thereon', paper in *Islamic Review*, London, May, 1966, pp. 10-16, and in *Islamic Thoughts*, July 1967 (PI0/43).

The major part of the paper describes the evil of interest and the banking systems based on interest. A brief sketch of interest-free banking is also presented (pp. 33-34). This system of banking would be run on the capital procured from the people on the basis of *muḍāraba*.

The bank can advance capital procured in this way, as well as the capital of its own shareholders, to businessmen, also on *muḍāraba*. As regards the distribution of profit and responsibility of loss, the position adopted is strictly in accordance with the *Sharī'a*. In the rest of the paper, *zakāt*, international banking and the problem of nationalising the banks are dealt with. On pp. 40-42, industrial, agricultural and saving banks are discussed, but a scheme suggested in connection with saving involves interest.

11 S.A. IRSHAD: *Interest-Free Banking*, Orient Press of Pakistan, Karachi (n.d.), 100 pp. (This is an English version of the same author's Urdu *Bilā Sūd Bankārī*.)

12 S. HASANNUZZAMAN: 'Interest-Free Consumption Loans and Consumer Behaviour', in *Some Economic Aspects of Islam*, pp. 147-164, Umma Publishing House, Bahadurabad, Karachi 5, 1964.

In this paper the effects of fluctuations in the rate of interest on the demand for consumer loans is discussed. The author points out that the idea that in an interest-free banking system, the demand for interest-free loans would be unlimited, is not based on any sound economic theory, because in the determination of this demand other social and economic factors are much more critical than the rate of interest.

C Arabic

13 Dr. Mahmud Abu SA'ŪD: *Khuṭūṭ-Raīsīya Fi'l Iqtiṣādal-Islāmī*, Maṭba'a Ma'tūq Ikhwān, Beirut, 1965, 96 pp.

Although the subject of interest-free banking is not explicitly discussed in this book, we mention it for the reason that a remarkable view is expressed in it of the monetary system. To the author, the basic defect in the modern economic system, more fundamental than interest, is that even with the passage of time the value of money does not decrease while the value of other commodities does. This basic defect can be removed by the principle of *zakāt* which demands that taxes be levied on money in such a way that in the course of time its value decreases. According to the author the chief function of money is as a medium of exchange not a 'store of value'. The latter concept of money is the root cause of all the evils, which may be removed simply by imposing taxes upon the accumulated amount of money. A practical expression of the view is to introduce stamped money: whosoever keeps a ten rupees note for a month, would then be liable to fix a stamp of a determined value on it for its use. In other words all money not in circulation (but instead accumulated) should be charged a prescribed monthly tax. In consequence, money would generally remain in circulation. After this reform, the functions of the banks would change considerably. In this way the surplus capital of the people would also be provided for entrepreneurial activities on the basis of profit-sharing through the bank (p. 51).

As regards losses in the business, it is asserted that their incidence would be minimised in the above system (p.52).

14 Dr. Mahmud Abū SA'ŪD: *Hal Yumkin Inshā' Bank-Islāmī la yaqūm 'ala al-Ribā,* Maktaba al-Manār, Kuwait, (date not mentioned), 20 pp.

Dr. Mahmud Abū Sa'ūd is a well-known economist who has long been thinking and writing on the subject of Islamic banking. The journal *Al-Muslimūn,* published several papers by him on the subject of interest. Some people in Kuwait questioned him about setting up interest-free banks. This booklet comprises his answers. His view on the reforms to be effected in the present economic system have already been explained above. In this booklet he contends that until the present system is reformed it will be difficult, and a tedious task, to rescue the banking system from the pollution of interest – the greatest problem is confronted in obtaining loans. If the basis of advancing loans to entrepreneurs is participation in the profit, the difficulty is that the existing laws prohibit the banks from directly undertaking business ventures. This prohibition aims at the protection of the rights of the account holders. At the end, (pp. 18-19), the author suggests an institution based upon the principles of co-operation, but expresses the view that this institution would not be a bank. It would be rather an institution for capital investment. He does not discuss the system in any detail.

15 Dr. Mohammad Abdullah AL-ARABI: *Al-Mu'āmalāt al-Masrafīya al-Mu'āsira Wa ra'y al-Islām Fīha,* Majalla al-Azhar, Cairo, Muharram 1385, May, 1965, 44 pp.

The author's above-mentioned English paper is a translation of this Arabic article, which was presented at the second conference of 'Majma' al-Buhūth al-Islāmīya' at Cairo.

16 Dr. Muhammad AZIZ: *'Awāmil al-Najāḥ Fi'l Masārif al-Lārabawīya,* Maktabatul Manār, Kuwait (date not mentioned), 32 pp.[1]

In this useful pamphlet, four issues are discussed: first, obtaining capital for interest-free banks; secondly the supply of savings in the accounts of these banks; thirdly, whether there is greater risk of loss in interest-free banks; and fourthly, how the accounts of these banks are to be maintained.

[1] This is most probably an Arabic version of an article written by Dr. Muhammad Uzair.

It is reiterated that in the interest-free Islamic economy, the trend of consumption would be weaker than in the existing economy, and in consequence there would be more saving (p.10). This opinion is controversial. For this reason, as well as for some other reasons, the interest-free banks would receive more capital than the banks dealing in interest (p.12). On pp.14 and 18, certain measures are indicated that would popularise the interest-free banks and persuade people to become account holders.

On pp. 19-26, is discussed the question of the greater possibilities of loss in the interest-free banks, as compared with the contemporary interest-charging banks. Then, through the analysis of positive cases, and theoretical reasoning, it is established that this apprehension is baseless. In fact, in modern times business transactions are carried out in such a scientific way that there are, in practice, only the remotest chances of loss. Moreover, as the bank would make its investments in numerous enterprises, even if it suffered a loss on account of one party, its overall business would not necessarily result in a loss, so far as other parties are concerned. As far as the liability for losses on account of sudden fluctuations in prices (due to recession) is concerned, even interest-charging banks are not immune. This issue is, therefore, out of the debate in a comparative study of the two systems. It may, however, be argued in favour of interest-free banking that its establishment would help in restricting commercial crises. The final pages (26-33) speak of the methods of accounting in the new system and contain useful proposals.

The pamphlet is an important work on the subject, although it appears that, while referring to the business partners' liability for losses, the principles of *muḍāraba* have not been kept in view (pp.20 and 33).

17 *Al-Lajna al-Taḥḍīriya li-Mashrū' Bait al-Tamwīl, al-Kuwaitī,* Al-matba'tul 'Asriya, Kuwait, (date not given), 21 pp.

For the last few years efforts have been made to set up an interest-free bank in Kuwait. Some experts in economics and some scholars of Islamic *fiqh* have also been participating in these efforts. This booklet is about that bank, published for study and

advice. The work is due to be given its final touches after a conference held in 1969.

The bank would be established as a joint stock company under the existing laws of the land and included among its objectives will be that it will discharge all banking functions on an interest-free basis by floating profitable business with its own capital as well as providing capital for other profitable enterprises also on an interest-free basis (section 4). For the establishment of this bank, 100,000 shares of 10 dinars each would be collected in order to raise capital to the tune of 1,000,000 dinars. No shareholder would be allowed to buy shares of more than 5,000 dinars. The company would be administered by a board of directors comprising 8 to 12 members selected by an assembly of shareholders. Every member of the board would have to own at least 1,000 shares.

Shareholding in the company would be tantamount to acceptance of all the decisions of the board of directors and strict adherence to the principles laid down in the byelaws of the bank (section 16). The bank will open two types of account for the general public. People who deposit their money on the condition that it will not be invested in any profitable business by the bank, will be able to withdraw their money at any time. This account is similar to current and savings accounts (section 57). Those who are willing to authorise the bank to invest their money in business would also be able to authorise the bank to invest their money in some particular business, or scheme (section 58). These deposits may be made tenable for a fixed period as well as for an indefinite period. Regarding deposits for a definite period, it would be specified how much notice would be required for withdrawal. Only the management committee would be empowered to accept the request regarding withdrawal of such capital prior to the scheduled period. But in such cases the profit of the current year or a portion of it would have to be forfeited (section 58). The company would be empowered to make investments in all types of business schemes. But it would not be authorised to invest more than 5% of its total capital in any one scheme, nor would it be authorised to invest more than 30% of its capital for long or medium term enterprises (section 63). All commercial, industrial

and agricultural projects, minerals, land, air and water transport services, business transactions of immoveable properties, and insurance, etc., will be included in the operation of the bank (sections 5 and 6). This bank would advance loans for small-scale production without charging any interest or profit (section 59). The company would also start *zakāt* accounts, in which shareholders, account holders and others would be allowed to deposit their *zakāt*, to be spent in accordance with the provisions of the *Sharī'a* (section 7). The account of the profit of the company would be prepared annually and at this time the capital invested for profit-yielding purposes would be combined with the capital raised by the shareholders. However, if the total profit is more than 20%, the shareholders would be paid an additional profit on their capital and its minimum limit would be 10% (section 59). The following section would regulate a system of distribution of profit:

Section 77: Certain percentage of gross profit, which would be determined by the board of management, would be paid against depreciation of the company's assets. In the same way under the Labour Act, a certain portion of the profit would be reserved to meet the legal obligation of the company under labour laws, which would be determined by an assembly of the shareholders.

Section 78: Distribution of the net profit, would be made according to the following methods:

Firstly, 15% would be transferred to a compulsory reserve fund. Secondly, 10% of the balance would be allocated to an optional reserve fund. Thirdly, an amount equivalent to paying the first 'dividend' of the profit, 5%, would be deducted from the balance. Fourthly, after that deduction, one of these 'dividends' (which would not exceed 10% of the balance) would be authorised by the general assembly of the shareholders for payment of their remunerations to members of the management committee.

Fifthly, whatever balance of profit remained, would be distributed among the shareholders as an additional profit. Or, if the management committee so desired, that part of the profit might be transferred to the account for the next year, or utilised to meet any extraordinary expenditure.

Section 80: The emergency reserve fund would be distributed

according to the decisions of the general assembly of the shareholders. The compulsory reserve fund would not be utilised for division among the shareholders. However, in the event of the bank's inability, in some year, to distribute a profit of 5%, the above fund could be made use of for profit.

In these byelaws, it is not clarified, who would bear losses in the business. This is so, presumably, because in the relevant laws of Kuwait, this point might have been covered, the company being subject to these laws. It is however, evident from section 80 that the principles of profit-distribution are so designed that losses can be compensated by retaining a portion of the profit in the form of reserve funds, and in practice no account-holders or shareholder would be liable to any loss. In the event of extraordinary profits the shareholders will receive more profits than account-holders and the directors will be entitled to special dividends in view of their meritorious services, but these dividends would be payable only if feasible after disbursement of 5% additional profit to shareholders and account-holders.

18 *Mashrū' Baitu'l Tamwīl al-Kuwaitī* (no other details given), 12 pp.

This pamphlet published by the same institution after a brief introduction of the scheme offers detailed explanation of the factors leading to its formulation. The basis of agreement for procurement of bank capital from shareholders is to be *muḍāraba* (p.11) and yet (p.10) it is stated that the position of account holders of the bank will be that of shareholders.

AUTHOR INDEX

SUBJECT INDEX

DR. MUHAMMAD NEJATULLAH SIDDIQI, born in 1931 at Gorakhpur (UP) India, was educated at the Muslim University Aligarh and Darsgah Jamat-e-Islami Rampur. Before joining the King Abdul Aziz University Jeddah as Professor of Economics in the International Centre for Research in Islamic Economics, he was professor and head, Department of Islamic Studies and for some years reader in economics at Aligarh University. During his early academic career he launched and edited a quarterly research journal *Islamic Thought*. He has authored and translated over a dozen books on Islam and Islamic Economics. Some of these are: *Economic Enterprise in Islam, Some Aspects of the Islamic Economy, Muslim Economic Thinking, Principles of Partnership and Profit-sharing in Islam* (Urdu), *Banking without Interest, Insurance in Islamic Economy* (Urdu), *Islam's Theory of Property* (Urdu), *The Road to Islamic Renaissance* (Urdu), Urdu translation of Qāḍī Abū Yūsuf's *Kitāb al-Kharāj* and Sayyid Quṭb's *al-'Adālah al-Ijtimā'īyah fi'l-Islām*. These contributions won Dr. Siddiqi the King Faisal International Prize for Islamic Studies in 1982.

BANKING WITHOUT INTEREST demonstrates that banking institutions can operate without difficulty if the principle of profit-sharing is substituted for the practice of fixed interest payments. This applies to commercial banking as well as central banking. Explaining with numerical examples how neither the creation of credit nor control over its supply would pose any problems in the change-over from interest to profit-sharing, the book also deals with such issues as bills of exchange and supply of short-term interest-free loans to businessmen, consumers and the government. The author also discusses the possible role of commercial shares and loan certificates in the interest-free financial market. He suggests a number of new 'instruments' which the central bank can use, in the absence of the Bank Rate, for controlling the volume of credit.